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CAPITAL FORMATION

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I. GENERAL CONSIDERATIONS

A. The Current Economic Setting

The performance of the U.S. economy for the last 20 months has been a serious concern to the Congress and the Nation. The combination of a prolonged decline in real Gross National Product, unemployment in excess of 8 percent, and continued inflation is a new experience for us. Prospects for a rapid real recovery in 1975 and 1976 without inflation in excess of 6 percent do not appear strong. Current projections for 1976 indicate that unemployment will be in excess of 7 percent.

The impact of slack aggregate demand and high interest rates on investment is apparent. At the beginning of 1975, investment in current dollars was projected to be 3.3 percent above the 1974 level. In subsequent surveys of expected 1975 outlays on new plant and equipment in the second and third quarter, however, these plans for additional investment have been reduced to 1.6 percent and 1.0 percent respectively. This means that in real terms, investment will decline by as much as 9 percent this year.

The decline in real investment this year coupled with rising interest rates suggests by 1977 or 1978 that the recovery may be hampered. While capacity utilization is now 75 percent in manufacturing (see Table 1); this low level reflects in part the recent massive inventory reduction which apparently is complete. In subsequent quarters, it seems likely that capacity utilization will increase to replenish depleted inventories as well as to meet rising consumer demand. A related problem involves the extent to which industry will have to make additional investments to satisfy environmental regulations. The share of total investment from environmental protection has increased from 4.9 percent in 1973 to 5.4 percent in 1974 and 1975. In some industries such investment is rising more rapidly than overall investment. (See Table 2.) And while an improved environment increases our standard of living, measured GNP does not reflect these improvements.

There is the possibility that inadequate investment in plant and equipment this past year may hamper the recovery later on, for if the stock of plant and equipment is substantially less than needed to meet future demands, strong pressures on prices may occur which in turn could force monetary policy to become even more restrictive. Of concern is the related possibility that our financial structure, composed of household, business, and public saving, may not provide sufficient funds at the appropriate time to support a level of investment in new plant and equipment which is consistent with the long-run goals of the economy: real economic growth of 3–4 percent or better, an unemployment rate of about 4 percent, and an inflation rate of no more than 3–4 percent.

TABLE 1.—MANUFACTURER'S OPERATING RATES, MARCH 1973 TO MARCH 1975

[Seasonally adjusted]

Industry and asset size	Operating rates (percent) 1973 Mar.	1973 June	1973 Sept.	1973 Dec.	1974 Mar.	1974 June	1974 Sept.	1974 Dec.	1975 Mar
All manufacturers	86	86	85	85	84	84	84	78	75
Asset size:									
$100.0 million and over	89	89	88	87	87	87	87	88	77
$10.0 to $99.9 million	83	83	83	82	83	83	81	75	73
Under $10.0 million	78	78	79	79	80	79	77	72	70
Durable goods [1]	86	86	85	84	83	84	84	76	74
Asset size:									
$100.0 million and over	89	89	88	86	85	85	87	79	77
$10.0 to $99.9 million	82	83	83	82	82	83	82	75	72
Under $10.0 million	79	79	78	78	78	77	76	68	66
Primary metals	87	89	89	89	80	90	90	82	79
Electrical machinery	85	82	82	80	84	85	83	78	73
Machinery, except electrical	88	86	87	86	89	88	89	87	84
Transportation equipment [2]	89	91	86	82	77	80	83	71	71
Motor vehicles	104	107	99	91	83	87	92	70	73
Aircraft	68	70	69	70	71	69	71	72	68
Stone, clay, and glass	81	83	83	83	84	81	81	70	68
Nondurable goods [3]	86	86	86	85	86	85	84	80	76
Asset size:									
$100.0 million and over	90	91	89	89	88	88	87	83	77
$10.0 to $99.9 million	84	83	82	83	83	82	80	76	75
Under $10.0 million	78	78	80	80	82	80	78	75	74
Food including beverage	81	80	79	82	82	81	79	77	77
Textiles	90	90	89	89	87	87	80	69	69
Paper	93	94	94	93	93	93	94	84	74
Chemicals	86	88	88	88	85	86	86	81	72
Petroleum	97	97	97	95	86	92	89	90	87
Rubber	89	91	90	84	89	88	86	77	65
Primary-processed goods [4]	88	89	89	89	87	87	86	79	75
Advanced-processed goods [5]	85	85	83	82	83	83	83	77	75

[1] Also includes producers of lumber, furniture, fabricated metals, instruments, and ordnance and miscellaneous manufacturers.

[2] Also includes producers of other transportation equipment.

[3]. Also includes producers of tobacco, apparel, printing and publishing, and leather.

[4]. Includes producers of lumber; stone, clay, and glass; primary metals; fabricated metals; textiles; paper; chemicals (at ½ weight); petroleum; and rubber.

[5] Includes producers of furniture, electrical machinery, machinery except electrical motor vehicles, aircraft, other transportation equipment, instruments, and ordnance and miscellaneous manufactures, food including beverage, tobacco, apparel, printing and publishing, chemicals (at ½ weight), and leather.

Source: Survey of Current Business, June 1975, p. 18.

TABLE 2.—NEW PLANT AND EQUIPMENT EXPENDITURES BY U.S. BUSINESS FOR THE ABATEMENT OF AIR, WATER, AND SOLID WASTE POLLUTION,[1] 1973–75

[Millions of dollars]

	1973		1974				1975			
	Total [2]	For pollution control	Total [3]	For pollution control	Percent change, 1973–74 total	Percent change, pollution 1973–74	Total [3]	For pollution control	Percent change, 1974–75 total	Percent change, pollution 1974–75
All industries	100,076	4,938	111,451	5,617	11.4	13.8	116,578	6,294	4.6	12.1
Manufacturing	38,003	3,153	45,795	3,656	20.5	16.0	49,917	4,167	9.0	14.0
Durable goods	19,389	1,579	22,669	1,648	16.9	4.4	23,083	1,794	1.8	8.8
Primary metals [3]	3,481	814	4,805	798	38.0	−2.0	5,495	871	14.4	9.1
Blast furnaces, steel works	1,407	230	2,030	245	44.3	6.5	2,554	293	25.8	−17.1
Nonferrous metals	1,679	523	2,292	500	36.5	−4.4	2,414	497	5.3	−18.6
Electrical machinery	2,895	129	3,060	207	5.7	72.5	2,877	193	−6.0	−6.8
Machinery except electrical	3,478	80	4,264	77	72.1	−3.8	4,624	100	0	29.9
Transportation equipment [4]	3,063	170	3,826	140	24.9	−17.6	3,509	147	8.3	5.0
Motor vehicles	2,244	143	2,812	115	25.3	−19.6	2,574	119	−8.5	3.5
Aircraft	531	20	766	22	44.3	10.0	687	25	−10.3	13.6
Stone, clay, and glass	1,503	144	1,483	191	−1.3	32.6	1,363	202	−8.1	5.7
Other durables [4]	4,969	243	5,231	235	5.3	−3.3	5,215	281	−.3	19.6
Nondurable goods	18,614	1,574	23,126	2,008	24.2	27.6	26,834	2,372	16.0	18.1
Food, including beverage	3,048	152	3,206	150	5.2	−1.3	3,196	177	−.3	18.0
Textiles	787	29	849	28	7.9	−3.4	704	33	−17.1	17.9
Paper	1,893	355	2,546	491	34.5	38.3	2,904	475	14.1	−3.3
Chemicals	4,324	416	5,628	469	30.2	12.7	7,157	573	27.2	22.2
Petroleum	5,409	555	7,868	796	45.5	43.4	10,068	1,016	27.9	27.6
Rubber	1,562	48	1,745	47	−5.9	−2.1	1,378	71	−6.6	51.1
Other nondurables [4]	1,586	19	1,554	28	−2.0	47.4	1,427	28	−8.2	0
Nonmanufacturing	62,073	1,785	65,656	1,961	5.8	9.9	66,661	2,128	1.5	8.5
Mining	2,759	91	3,097	57	12.3	−37.4	3,672	47	18.6	−17.5
Railroad	1,939	16	2,484	29	28.1	81.3	3,172	37	27.7	27.6
Air transportation	2,413	15	1,970	7	−18.4	−53.3	1,781	11	−9.6	57.1
Other transportation	1,605	11	2,034	46	26.7	318.2	2,337	64	14.9	39.1
Public utilities	19,087	1,451	20,597	1,622	7.9	11.8	21,462	1,735	4.2	7.0
Electric	16,250	1,409	17,649	1,578	8.6	12.0	17,869	1,683	1.2	6.6
Gas and other	2,837	42	2,948	44	3.9	4.8	3,595	52	21.9	18.2
Communication, commercial and other [5]	34,270	201	35,474	201	3.5	0	34,237	235	−3.5	16.9

1 Excludes agricultural business; real estate operators; medical, legal, educational; and cultural services; and nonprofit organizations. Excludes outlays charged to current account.

2 Preliminary. Estimates are as of survey date to allow comparisons with pollution abatement estimates. The 1973 BEA survey did not cover solid waste disposal.

3 Estimates are based on expected capital expenditures reported in late November and December 1974. Estimates for 1975 were adjusted when necessary for systematic biases in expectational data.

4 Includes industries not shown separately.

5 Includes trade, service, construction, finance, and insurance.

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

Source: Survey of Current Business, July 1975.

The possible shortfall in saving and investment has been called the "capital shortage problem." It should be noted that the possible problems outlined above will not cause a shortage of capital in the sense of lines and possible blackmarket activity, but rather a pattern of economic performance that is below our expectations.

The relation of savings to investment may be described first in terms of their accounting relationship in the GNP accounts. In our GNP accounts, aggregate savings must necessarily equal aggregate investment. More specifically, private saving composed of personal saving and business saving, and a Government surplus or deficit necessarily equals gross domestic plus foreign investment. Investment may then be higher or lower as individual and business savings decisions and Federal, State and local business decisions are made. As individuals and firms adjust their consumption and therefore savings plans throughout the year and business adjust their plant and equipment and inventory plans, differences between intended saving and investment may occur. However, in an accounting sense. these differences in plans must net out, as plans and expectations of savers and investors are adjusted over the year.

This accounting relationship of savings to investment is important to note, for it highlights the fact that there are three basic sources of savings in the economy. To the extent we seek to permanently increase aggregate investment, we must turn to these three sources of savings to ultimately support it.

Table 3 indicates the magnitude of aggregate savings since 1950, the gross savings rate (gross savings as a percent of GNP), and real GNP growth rate. Of interest is that gross business savings has been about twice personal savings; net public (Federal, and State, and local) sector saving has been positive in 11 of the last 25 years; and strong economic growth and high savings rates are not always closely related.

Over the last 25 years, the total savings rate averaged 15.4 percent and the growth rate averaged 3.8 percent. In 16 of the 25 years, above average growth and above average savings rates or below average growth and below average savings rates occured. In the other 9 years, economic growth was above average and savings below average, or economic growth was below average and savings were above average. Thus, in 16 of the 25 years, the relationship between the savings rate and economic growth was positive.

Savings affects long-term growth prospects by altering, through the investment process, the stock of productive capital. In the long run, both the level and quality of capital and labor will aid economic growth. Until the economy is functioning at, or very close to full employment and at a high degree of capacity utilization, the level of capital and labor available in the economy are not, however, binding constraints on economic growth.

TABLE 3.—GROSS SAVINGS IN BILLIONS OF CURRENT DOLLARS

Year	Grand total	Private: Total	Private: Personal	Private: Gross business	Government surplus or deficit: Total	Government surplus or deficit: Federal	Government surplus or deficit: State and local	Gross savings rate	GNP real rate of growth
1950	50.4	42.5	13.1	29.4	7.9	9.1	−1.2	17.7	9 6
1951	56.1	50.3	17.3	33.1	5.8	6.2	−.4	17.1	7.9
1952	49.5	53.3	18.1	35.1	−3.8	−3.8	----------	14.3	3.0
1953	47.5	54.4	18.3	36.1	−6.9	−7.0	.1	13.0	4.5
1954	48.5	55.6	16.4	39.2	−7.0	−5.9	−1.1	13.3	−1.4
1955	64.8	62.1	15.8	46.3	2.7	4.0	−1.3	16.3	7.6
1956	72.7	67.8	20.6	47.3	4.9	5.7	−.9	17.3	1.8
1957	71.2	70.5	20.7	49.8	.7	2.1	−1.4	16.1	1.5
1958	59.2	71.7	22.3	49.4	−12.5	−10.2	−2.3	13.2	−1.1
1959	73.8	75.9	19.1	56.8	−2.1	−1.2	−.8	15.3	6.4
1960	77.5	73.9	17.0	56.8	3.7	3.5	.2	15.4	2.5
1961	75.5	79.8	21.2	58.7	−4.3	−3.8	−.5	14.5	1.9
1962	85.0	87.9	21.6	66.3	−2.9	−3.8	.9	15.2	6.6
1963	90.5	88.7	19.9	68.8	1.8	.7	1.2	15.3	4.0
1964	101.0	102.4	26.2	76.2	−1.4	−3.0	1.7	16.0	5.4
1965	115.3	113.1	28.4	84.7	2.2	1.2	1.0	16.8	6.3
1966	124.9	123.8	32.5	91.3	1.1	−.2	1.3	16.7	6.5
1967	119.5	133.4	40.4	93.0	−13.9	−12.4	−1.6	15.1	2.6
1968	128.3	135.2	39.8	95.4	6.8	−6.5	−.3	14.8	4.7
1969	144.0	135.2	38.2	97.0	8.8	8.1	.7	15.5	2.7
1970	143.1	153.2	56.2	97.0	−10.1	−11.1	1.8	14.6	−.4
1971	152.2	170.7	60.5	110.2	−18.5	−21.9	3.4	14.4	3.3
1972	173.3	178.5	52.6	125.9	−5.1	−17.5	12.3	15.0	6.2
1973	214.4	210.9	94.9	136.5	3.3	−5.6	9.2	16.6	5.9
1974	207.3	213.2	76.7	136.5	−5.9	−7.6	1.7	14.8	−2.2
1950–74 average								15.4	3.8

Source: Derived from tables C–20, C–1, and C–2 of 1975 Economic Report of the President.

Over the period 1948–69 for which data are available, national income in constant prices grew at 3.8 percent per year. Of this, 2.10 percentage points is attributable to higher *levels* of labor and capital (1.30 and .80, repsectively), and 1.75 percentage points is attributable to the improvement in *productivity* or *quality* of capital and labor. By far the biggest source of improved productivity of these inputs was through improvements in technology and advancements in knowledge (1.19 of the 1.75 percent). With respect to the contribution of higher levels of nonresidential structures and equipment investment, such increased levels of fixed investment contributed about half of the .80 contribution of overall capital. Thus, overall, new plant equipment accounted for one-tenth of the 3.8 growth in real output.[1]

While investment contributes significantly to the pace of economic growth, the committee may wish to consider the extent to which investment can be effectively encouraged during a particular time period. The investment credit was increased in 1975 from 7 to 10 percent; however, the level of investment planned for this year has been repeatedly scaled down. Thus, other factors, most notably slack demand for final goods and services and high interest rates, have affected investment spending and may frustrate particular tax policies designed to quickly increase investment in the future. Of course, investment may have been lower than without the increase in the credit. Also, the impact of the credit may yet be felt. Its impact on investment is generally thought to lag from 4 to 10 quarters from time of enactment. This in part reflects the fact that investment in new plant and equipment involves considerable planning and construction time.

[1] Edward Denison, *Accounting for United States Economic Growth: 1929–1969*, Brookings, 1974, Table 9–4.

In addition, to aggregate efficiency considerations, there are certain compositional effects that result from policies designed to stimulate investment. In circumstances where business investment is initially encouraged by reason of certain tax reductions (such as by increasing the credit from 7 percent to 10 percent), it may follow that investment in other sectors, e.g., residential housing, will decline. This may occur because housing does not benefit from the credit. Accordingly, capital will flow from housing to the business sector as the return on business capital rises. Similarly, to the extent the committee wishes to consider tax changes which will increase the return to corporate capital, for example, a cut in the corporate tax rate, it should consider that resources in the noncorporate sector (housing and agriculture) will be induced to move to the corporate sector by the higher rate of return. Over time, the net returns will be equalized, but in the short run, investment will move to the corporate sector and out of the noncorporate sector.

B. U.S. Economy in Perspective

Several areas of the economy have been identified as providing, either by themselves or in comparison to other countries, evidence that there will be a shortfall of physical investment in the years ahead to achieve national economic goals. These involve comparisons of growth rates, evaluations of U.S. productivity trends, analyses of unit labor costs, and the relation of corporate debt to equity outstanding in recent years.

Over 1963–1973, for which comparable data are available for OECD countries, the U.S. averaged 4.3 percent real growth in GNP. This exceeded Sweden, Italy, the United Kingdom, and was less than West Germany (4.7 percent), Canada (5.5 percent), and Japan (10.3 percent). (See table 4.) There are several countries which, as a consequence of "economic maturation," experienced decelerations in their rate of economic growth. For example, West Germany grew over the period 1950–62 at a 7.3 percent rate; but over the period 1963–1973, it grew only a 4.7 percent rate. Similarly, Italy has slowed down from a 6.0 percent growth rate to 2.9 percent growth in this more recent period. Japan, however, remains an exception.

TABLE 4.—GROWTH IN REAL GROSS DOMESTIC PRODUCT: 1963–73

[Percent increase]

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Average rate
United States [1]	4.0	5.4	6.3	6.5	2.6	4.7	2.7	−0.4	3.3	6.2	5.9	4.3
Canada	5.5	6.4	6.8	7.0	3.4	5.6	5.2	2.6	5.6	5.7	6.8	5.5
Japan	10.5	13.3	5.1	9.8	12.9	13.5	10.9	10.9	7.3	8.5	10.2	10.3
United Kingdom	4.0	5.6	2.1	2.0	2.4	3.5	1.1	2.1	2.3	3.1	5.4	3.1
France	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	5.4	5.5	5.8	5.6
West Germany	3.4	6.8	5.6	2.9	−.2	7.1	8.2	6.0	2.9	3.4	5.3	4.7
Italy	3.2	3.6	3.2	3.9	2.3	2.9	2.0	2.6	2.8	2.9	2.9	2.9
Sweden	4.9	6.6	4.1	2.3	3.2	3.9	5.1	4.6	.5	2.8	3.3	3.7

[1] Refers to growth in real gross national product rather than domestic product from table 1. OECD data for United States would otherwise be only available for 1969–73.
[2] Not available.

Source: National Accounts of OECD Countries, 1975, table 1.

While U.S. economic growth may be more modest than that of our European trading partners, it should be pointed out that in addition to the slowing down most have more recently experienced, their continued expansions have been at the expense of price stability. As Table 5 demonstrates, our inflation rate has been considerably below those of other major industrial countries. Also, it should be noted that since World War II the U.S. has devoted a far greater share of its real resources to national defense than these other countries. Because such public outlays represent claims on real resources that might otherwise be needed for the production of future consumption goods, national defense outlays are generally thought to retard the expansion of potential capacity and therefore potentially limit economic growth. It is difficult to speculate about what would happen if, say, 1 percent of GNP, representing a share of public revenue and corresponding defense outlays, were returned to the private sector while the economy was at full employment. It would appear, however, that potential GNP would rise. Were the economy not at full employment, the reverse might occur as insufficient aggregate demand, rather than inadequate supply, would be the economic problem requiring attention.

TABLE 5.—INFLATION RATES [1] IN SELECTED COUNTRIES

[Percent increase]

	1960–72 average	1970	1971	1972	1973	1974
United States	2.9	5.5	4.5	3.3	5.6	10.2
Canada	3.4	4.8	3.1	4.8	7.6	13.0
Japan	4.8	6.7	4.6	5.0	12.1	24.0
United Kingdom	4.9	7.3	8.9	7.8	7.4	11.0
France	4.5	5.6	5.4	5.7	7.6	10.0
West Germany	4.0	7.0	7.9	6.0	5.8	6.5
Italy	4.8	6.7	6.7	6.0	10.3	15.2

[1] Entries refer to GNP deflators.

Source: International Economic Report of the President, 1975, table 4.

Another aspect of the economy, growth in worker productivity, has been identified as being a potential bottleneck to rapid economic growth. Table 6 indicates that over 1960–1974 the growth in output per hour of labor in the U.S. indeed has been lower than in other industrialized countries. For that period, U.S. productivity grew 3.5 percent a year while in Canada and Great Britain it grew 4.2 percent a year. The other countries experienced faster increases in productivity growth. However, if we focus on more recent experience (1970–1974), we find the U.S. fares much better in these comparisons. During this later period, U.S. productivity grew at an average rate of 4.7 percent while Canada and Great Britain grew at 4.0 percent.

TABLE 6.—GROWTH IN OUTPUT PER HOUR OF LABOR IN MANUFACTURING, 12 COUNTRIES, 1960–74

[Average annual percent change]

Year [1]	United States	Canada	Japan	France	Germany	Italy	Sweden	United Kingdom
1960–61	2.4	5.4	12.9	4.6	5.5	3.5	5.1	0.8
1961–62	5.8	5.3	4.4	4.6	6.3	10.0	7.6	2.5
1962–63	4.1	3.8	8.3	5.9	5.3	3.2	7.9	5.4
1963–64	4.9	4.4	13.2	5.1	7.8	6.6	7.9	7.2
1964–65	4.1	3.8	4.2	5.7	7.0	12.4	8.1	3.1
1965–66	1.6	2.9	10.1	7.0	4.0	4.9	4.3	3.6
1966–67	.0	2.9	14.8	5.6	6.4	4.2	8.2	4.4
1967–68	4.7	7.3	12.6	11.4	7.6	8.4	10.1	6.7
1968–69	2.6	5.6	15.5	3.7	5.8	3.5	7.3	1.3
1969–70	.4	1.7	12.7	5.0	2.5	5.0	4.5	.9
1970–71	6.8	6.7	3.5	5.2	5.1	4.4	4.6	4.7
1971–72	5.6	4.2	8.0	6.8	6.3	8.4	7.1	4.1
1972–73	5.5	3.9	18.1	5.8	6.9	9.5	7.0	7.0
1973–74	.7	1.4	3.1	3.4	2.9	(2)	−.9	.3
1960–74 average	3.5	4.2	10.1	5.7	5.7	6.5	6.3	4.2
1970–74 average	4.2	4.0	8.2	5.3	5.3	7.4	4.4	4.0

[1] Preliminary estimates for latest year.
[2] Not available.

Note: The data relate to all employed persons (wage and salary earners, the self-employed, and unpaid family workers) in the United States and Canada, wage earners in Switzerland, and all employees (wage and salary earners) in the other countries.

Source: U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, July 1975.

A third aspect of U.S. economic performance that has been identified involves the growth in U.S. labor costs per unit of output viz-a-viz our trading partners. Were labor costs to escalate more rapidly here than elsewhere, final prices of U.S. goods would rise more quickly on international markets and adversely affect our balance of trade. Over the past 15 years, U.S. labor costs have actually grown less quickly than in every other country except Canada (see Table 7). Over this period, unit labor costs in the U.S. grew at an average of 2 percent a year, while in other countries such as France and Germany, they grew at an average of 4.7 percent a year. The more recent experience is even more favorable to the United States. In 1973–74, unit labor costs rose worldwide. While the rise was 8.8 percent in the United States, it was 11.6 percent in Canada, 29.4 percent in Japan, 15.4 percent in France, 11.6 percent in Germany, 17.8 percent in Sweden, and 19.8 percent in Great Britain (see Table 7).

TABLE 7.—GROWTH IN UNIT LABOR COSTS IN MANUFACTURING, NATIONAL CURRENCY BASIS, 12 COUNTRIES, 1960–74

[Average annual percent change]

	United States	Canada	Japan	France	Germany	Italy	Sweden	United Kingdom
1960–61	0.6	−2.7	3.1	5.2	5.9	2.5	4.5	6.9
1961–62	−1.5	−2.3	4.4	5.2	6.3	6.4	4.0	2.7
1962–63	−.7	−.2	3.2	4.3	1.5	15.4	4.6	−.8
1963–64	−.3	−.6	−.7	2.4	−.0	5.5	.0	−.1
1964–65	−1.5	1.1	8.0	1.8	2.7	−3.8	1.8	6.1
1965–66	2.9	4.8	.2	−.6	4.8	−2.1	5.0	4.7
1966–67	4.9	4.6	−2.5	2.6	−.5	5.1	2.3	−1.5
1967–68	2.3	−.1	3.2	1.8	−1.5	−1.1	−.7	.4
1968–69	3.8	1.8	2.5	2.1	3.0	6.0	1.8	6.6
1969–70	6.7	6.0	5.4	6.7	12.4	14.3	5.5	13.7
1970–71	.0	.9	11.8	6.4	8.4	13.4	7.4	9.0
1971–72	.1	−3.0	7.1	4.7	5.1	5.7	5.1	8.6
1972–73	1.5	4.4	5.3	7.4	6.0	12.8	3.5	5.9
1973–74	8.8	11.6	29.4	15.4	11.6	(2)	17.8	19.8
Average	2.0	1.9	6.1	4.7	4.7	6.2	4.5	5.8

1 Preliminary estimates for latest year.
2 Not available.

Note: The data relate to all employed persons (wage and salary earners, the self-employed, and unpaid family) in the United States and Canada, wage earners in Switzerland, and all employees (wage and salary) in the other countries.

Source: U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, July 1975.

The fact that the ratio of outstanding debt to outstanding equity has increased has been identified as another indication that there is a capital formation problem in the United States. Since the mid-1960's the ratio has moved upwards. As a consequence, interest payments have become a significant factor in corporate balance sheets, and to some, an excessive factor. Table 8 shows the *flow* of new debt and new equity (net new issues and gross retained earnings) since the mid-1960's and provides 1959 as a point of comparison. The ratio has increased from .28 in 1959 to .55 in 1968. It dropped to .45 in 1971, and then markedly increased in 1973 to .65 and to .85 in 1974. Preliminary figures for 1975 suggest a possible reversal of this trend; the second quarter flow of debt to equity on an annual basis is .27. With rebounding profits, firms are retiring or replacing the short-term debt which they built up in 1973 and 1974.

TABLE 8.—CORPORATE DEBT AND EQUITY RELATIONS

[Billions of current dollars]

Year	(1) Debt	(2) Gross internal funds	(3) Net new shares	Debt-equity ratio (1) / (2)+(3)
1959	10.5	35.0	2.1	0.28
1965	20.4	56.6	1 −0	.36
1966	24.0	61.2	1.3	.38
1967	27.2	61.4	2.4	.43
1968	31.7	61.7	1 −.2	.52
1969	35.5	60.7	3.4	.55
1970	33.8	59.4	5.7	.52
1971	35.4	68.0	11.4	.45
1972	44.4	78.7	10.9	.50
1973	59.7	84.6	7.4	.65
1974	73.0	81.5	4.1	.85
1975	2 25.6	2 89.3	2 6.2	2 .27

1 Net withdrawals of equity.
2 Based on 2d quarter, 1975, annualized data.

Source: Board of Governors, Federal Reserve System, "Flow of Funds Accounts," 1965–73, p. 6; "Flow of Funds of Funds, Seasonally Adjusted, 2d Quarter, 1975" (preliminary).

C. Summary of Major Investment and Savings Projections, 1975 to 1980

There have been several major studies of capital needs in the coming decade and the ability of our financial structure to provide funds to meet these needs. The studies are very complex, and defy an easy characterization. A central theme in virtually all of them, however, is (a) the absence of any physical production or capacity bottlenecks over the next two or three years, (b) the absence of any financial bottlenecks in financing investment over the next two to three years, (c) the importance in the long-run of public sector saving (a budgetary surplus) or dissaving (a budgetary deficit) on the prospects for financing investment in productive plant and equipment, and (d) the potentially adverse effect of an overly cautious monetary policy in 1977 and thereafter.

It should be borne in mind that long-term (three to ten years) economic forecasting is relatively undeveloped as compared to short-term forecasting. Also, unforeseen events (e.g., another oil embargo or other major disruptions in world trading or commodity prices) cannot as a necessity be factored into these long-run projections. Rather, one must assume no external "shocks" to our economy. Finally, assumptions must be made not only about private market behavior, but also about the future course of tax, budget and monetary policy. Again, the ultimate adequacy of these forcasts rests not only on the economic models used, but also on the plausibility of particular assumptions entertained about the future course of economic policies.

1. The Bosworth-Duesenberry-Carron Study [1]

This study pieces together the sources of potential output to 1980 in the private and public sector and then match this analysis of investment requirements against likely sources of aggregate savings.

New projections overall are that gross private domestic capital formation for 1980 will be 15.8 percent of GNP. They point out this is above the 1960–70 average of 14.8 percent and the 1953–70 average of 15.0 percent. As Table 1 indicates, the required 15.8 percent is close to our 1950–74 experience—15.4 percent. Once the economy is at full employment, private investment is projected to exceed private saving. Accordingly, the high investment rate can be realized only through aggregate public saving—such as via a budgetary surplus. As in other studies, the ease with which investment requirements can be financed at the end of the forecast period (1980 in this case) depends on the adequacy and timeliness of the recovery over the period 1975–77.

2. Sinai-Brinner Study [2]

The authors use the long-term Data Resources econometric model under two basic policy assumptions about the recovery (1976–78) and accompaning monetary policy. Post-1980, the model is allowed to work out its long-run solution for growth, employment, investment,

[1] Bosworth-Duesenberry-Carron, *Capital Needs in the Seventies* (Washington, D.C.: Brookings. 1975).

[2] Sinai-Brinner, "Special Study: The Capital Shortage—Long-term Economic Projections: 1975–1990." *The Data Resources U.S. Long-term Review*, Summer 1975.

and the price level. Under their smooth growth recovery assumption, the demand for goods and funds does not exceed the ability of the economy to meet them until 1980. By 1977, under existing tax law and under reasonable expenditure assumptions (seven percent growth per year), they foresee Federal surpluses occuring, which as Bosworth, Duesenberry and Carron presume, will be a significant source of aggregate saving to finance investment needs. The basic progressivity of the individual income tax provides a revenue growth rate of 9.6 percent per year. Business spending for plant and equipment is expected to rise at a 10.6 percent growth rate, which is above historical growth rates. While corporate cash flow is expected to grow upon a return to full employment, internal funds are expected to provied 69 percent of total investment funding; this is comparable to our 1965–69 experience (70 percent), but above the 59 percent of 1970–74. Post-1980, however, they foresee possible strains in financial markets to meet inevstment financing requirements; for example, they foresee high grade corporate bonds requiring nine percent to sell, along with a prime rate of 8 to 8.5 percent in the period 1981–1984.

Under the second policy assumption—a very vigorous recovery in 1976–78—they anticipate much more cyclical behavior in the economy than several other studies with periods of credit stringency in 1978 and 1982. Also, they expect investments to depend more heavily than in the past on external sources of funding.

3. Evans-Chase Econometrics [8]

The Evans-Chase forecast over 1975–76 is for a real growth rate of about six percent coupled with an inflation rate of 6.8 percent. By 1977, however, prices are expected to rise more quickly, and monetary policy is expected to become more stringent. Medium-term pressure on prices is expected because: (a) foreign demand for grains will eliminate possible supply surpluses (and, thus eliminate price reduction pressures); (b) energy prices, especially for imported oil, will rise strongly upward by about 10 percent a year; (c) commodity prices will rise in part, due to speculation; and (d) long-term interest rates will maintain at a higher level, in part because of Federal deficits in 1975 and 1976 and because of monetary policy.

Over the period 1975–1984, the Evans-Chase forcast is for real GNP to rise at 3.6 percent annually and prices at 6.5 percent. According to their projections, the labor market is particularly depressed. This may result from their assuming rapid increases in benefits along with strong wage demands in response to the generally higher rate of inflation. In addition, above-equilibrium real wages then continues to cause chronic unemployment, which reaches 10 percent at one point in their projections.

II. TAX POLICIES FOR STIMULATING INVESTMENT AND SAVINGS

Overview

There are a variety of tax policies available to alter the profitability of business investment and potentially to increase aggregate savings and investment in the economy. Several major approaches have been

[8] Evans-Chase Econometrics, *Long-term Forecast: The Next Ten Years; Inflation, Recession, and Capital Shortage* (August, 1975).

suggested: (1) liberalization of the investment credit (including movies, television films and electric utilities); (2) liberalization of depreciation allowances; (3) integration of the corporate and individual income taxes; (4) a cut in the corporate income tax; (5) more favorable treatment of net operating losses; (6) more favorable treatment of personal savings; and (7) consideration of Sweden's investment reserve fund. Each of these categories of tax policy seeks to improve business return on investment by reducing business taxes. While similar in intent, each has a different effect on particular industries. For example, the investment credit provides tax relief for all eligible investment while a cut in the corporate rate will benefit corporate profits and leave the noncorporate sector at the same level of taxation.

A second aspect of these proposals is their impact on the economy in the short-run versus the long-run. Thus, the committee may wish to distinguish between business tax policies which increase investment in the short-runs but may not in the long-run, as compared to those policies which increase the gross investment rate in the long-run. When resources are idle, investment demand can be increased and ultimately financed without substantial difficulty. However, when the economy reaches full employment, a permanently higher rate of investment can be achieved only through a higher savings rate. If at full employment savings behavior does not permanently change, interest rates will rise and the incremental investment which is desired will be forestalled.

Most of the above-mentioned tax policies increase the after-tax return to capital. Investment will then proceed to increase in response to this more attractive return. If, however, aggregate savings in the economy does not also respond to these higher returns, interest rates will rise. Thus, when the distinction is drawn between short-run incentives for investment to encourage investment for stabilization purposes, and the long-run goal of raising the level of capital in the economy at full employment, the importance of the three sources of saving must be recognized (household, business, and public). Also, as noted earlier, achieving a permanent increase in the investment rate (and thus savings rate) may contribute only in part to a more pronounced rate of long-term growth. Other factors such as the rate of innovation and long-term population growth will also have a material bearing on the extent to which the real growth rate can be increased.

A. Investment Tax Credit

Present Law

Present law provides a 10-percent investment credit for the period beginning January 22, 1975, and ending December 31, 1976. (For the period when the basic rate is 10 percent, a corporate taxpayer may elect an 11-percent credit if an amount equal to the additional one percent is contributed to an employee stock ownership plan.) Thereafter, the rate is to revert to 7 percent (4 percent with respect to certain public utility property). The investment credit is available with respect to: (1) tangible personal property; (2) other tangible property (not including a building and structural components) which is an integral part of manufacturing production, etc., or which constitutes a research or storage facility; and (3) elevators and escalators. Generally, the credit is not available with respect to property used outside the United States.

To be eligible for the credit, the property must be depreciable property with a useful life of at least 3 years. Property with a useful life of 3 or 4 yars qualifies for the credit to the extent of one-third of its cost; property with a useful life of 5 or 6 years qualifies with respect to two-thirds of its cost; and property with a useful life of 7 years or more qualifies for the credit to the full extent of the property's cost. (However, in the case of used property, not more than $50,000 of cost may be taken into account by a taxpayer as qualified investment for purposes of the credit for a taxable year. For 1975 and 1976, the $50,000 limit is increased to $100,000.)

Generally, property becomes eligible for the credit when it is placed in service. Property is considered to be placed in service in the earlier of (1) the taxable year in which depreciation on the property begins, or (2) the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function. The investment credit is also available before the property is placed in service, as progress expenditures are made.

The amount of the credit that a taxpayer may take in any one year cannot exceed the first $25,000 of tax liability (as otherwise computed) plus 50 percent of the tax liability in excess of $25,000. Investment credits which because of this limitation cannot be used in the current year may be carried back 3 taxable years and then carried forward 7 taxable years and used in those years to the extent permissible within the limitations applicable in those years. (In the case of public utility property, the 50-percent limit is increased to 100 percent for 1975 and 1976, 90 percent for 1977, 80 percent for 1978, 70 percent for 1979, and 60 percent for 1980.)

Present law provides for a recapture of the investment credit to the extent property is disposed of before the end of the period (that is, 3–5, 5–7, or 7 or more years) which was used in determining the amount of the credit originally allowed. Thus, if property is disposed of, or otherwise ceases to be qualified, the tax for the current year is increased (or unused credit carryovers are reduced) by the reductions in investment credits which would have resulted if the credit were computed on the basis of the actual useful life of the property rather than its estimated useful life.

Public utility property to which the 4-percent investment tax credit is to apply after December 31, 1976, is property used predominantly in the trade or business of furnishing or selling (1) electrical energy, water, or sewage disposal services, (2) gas through a local distribution system, or (3) telephone service, telegraph service through domestic telegraph operations, or other communications services (other than international telegraph services). In general, the reduced credit applies only if the rates for these services or items are established or approved by certain types of governmental regulatory bodies.

With respect to the treatment of the investment credit of regulated companies for ratemaking purposes, special limitations are imposed on the allowance of the credit to prevent the tax benefits of the credit from immediately being passed on to the consumers. These limitations are applicable to property used predominantly in the trade or business of furnishing or selling (1) the products or services described in the preceding paragraph and (2) steam through a local distribution system or the transportation of gas or steam by pipeline, if the rates for those businesses are subject to government regulation.

The special limitations generally provide that the investment credit is not to be available to a company with respect to any of its public utility property if any part of the credit to which it would otherwise be entitled is flowed through to income (i.e., increases the utility's income for ratemaking purposes); however, in this case the tax benefits derived from the credits may (if the regulatory commission so requires) be used to reduce the rate base, if this reduction is restored over the useful life of the property.

If, within 90 days after enactment of the Revenue Act of 1971 the taxpayer has so elected, then the investment credit is to be available to the taxpayer with respect to any of its public utility property if the credit to which it would otherwise be entitled is flowed through to income ratably over the useful life of the property; however, in this case there must not be any adjustment to reduce the rate base. An additional elective rule was provided to permit certain types of utilities (primarily electric utilities) to immediately flow through benefits to consumers. Immediate flow through is permitted in situations where the tax benefits of accelerated depreciation rules enacted under the Tax Reform Act of 1969 are flowed through to consumers. This election was provided in recognition of the special competitive conditions under which a company subject to the accelerated depreciation flow-through rules was operating. A special election is provided with respect to local steam distribution systems and gas or steam pipelines where the regulatory body involved determined that the natural domestic supply of gas or steam was insufficient to meet the present and future requirements of the domestic economy. In this case, if the taxpayer elected (within 90 days after enactment of the Revenue Act of 1971) the investment credit is not to be available unless (1) no part of the credit is flowed through to income, and also (2) no part of the credit is used to reduce the rate base.

The rules with respect to the additional investment credit for 1975 and 1976 generally follow those for the 4-percent credit, as enacted in 1971.

Legislative History

Revenue Act of 1962.—A credit equal to 7 percent of qualified investment was provided with respect to most types of tangible personal property and investment in certain limited types of real property which were used directly in manufacturing, production, or transportation (not including a building and structural components). Qualified investment included only investment in either new or used property having a useful life in excess of four years; a $50,000 limitation was provided with respect to used property. Property with a useful life of four to six years obtained a one-third credit; property with a useful life of six to eight years obtained a two-thirds credit; and property with a useful life of eight years or more qualified for the full credit. Credit for public utility investment was limited, in effect, to three percent of qualified investment.

of utilities) which could be obtained was not to exceed an amount equal to the first $25,000 of the taxpayer's income tax liability (determined without regard to the credit), plus an amount equal to 25 percent of the tax liability in excess of $25,000 (determined without regard to the credit). Credits could be carried back to three prior taxable years, and, to the extent not usable under this provision, carried forward to five succeeding taxable year. In computing the applicable amount of carryback and carryforward, the investment credit remained subject to the above limitations and any investment credit earned during the taxable year was required to be used before any applicable carryback or carryforward.

In addition, the 1962 Act included a provision to reduce the basis (for depreciation) of the property by the amount of the 7-percent credit (but see 1964 Act repeal of this provision).

The Revenue Act of 1964.—Certain modification to the investment credit were made: the original provision that the basis of property eligible for depreciation be reduced by the amount of the claimed investment credit, was repealed. Also Federal regulatory commissions were prohibited from requiring the "flow through" of any of the benefits of the investment credit to the customers of the regulated industries, more rapidly than ratably over the relevant property's useful life (in some cases, flow through was prohibited altogether). The credit was made available in the case of elevators and escalators, and the base was increased on which the credit of the lessee would be computed where dealers lease property eligible for the credit.

1966 Act Suspending the Investment Credit and Limiting the Use of Accelerated Depreciation.—The investment credit was suspended from October 10, 1966, through December 31, 1967, in order to moderate the pace of economic activity and to balance demand among the various sectors of the economy. An exception was provided for up to $20,000 of investment by each taxpayer during the period. Water and air pollution control facilities retained eligibility for the investment credit and accelerated depreciation if used to reduce either form of pollution by removing, altering, or disposing of pollutants.

Accelerated depreciation on buildings (which normally were not eligible for the investment credit) was also suspended. An exception of up to $50,000 of construction for each taxpayer was provided. The suspension applied to the sum-of-the-years-digit method and declining balance depreciation at a rate greater than one and one-half times the applicable straight line rate.

Transition rules were provided to allow the credit and accelerated depreciation method for property whose physical construction began before the suspension, for buildings for which 50 percent of basis was under construction, or for machinery and equipment of which 50 percent of the parts and components were held prior to the suspension if such parts and components were a significant portion of total costs.

After December 31, 1967, the amount of the credit which could be claimed for a taxable year, including carryovers, was to be an amount equal to the entire tax liability up to $25,000 and 50 percent of any tax liability over $25,000. The carryforward period was extended to 7 years.

1967 Restoration of Investment Credit and the Allowance of Accelerated Depreciation in the Case of Certain Real Property.—In June 1967, the suspension of the investment credit and accelerated depreciation was removed as of March 9, 1967. (The 1966 Act had provided for a December 1967 reinstatement date.) Accelerated depreciation was not to apply to the construction, etc., begun on or before May 24, 1967. Under prior law, property used predominantly outside the United States did not qualify for the investment credit. The 1967 Act extended an exception to this rule for any aircraft which was registered with the Federal Aviation Agency and which was operated to or from the United States.

Tax Reform Act of 1969.—The 1969 Act repealed the investment credit. The 1969 Act also provided that the investment credit was not to be available with respect to property on which physical construction, reconstruction, or erection began after April 18, 1969, or which was acquired by the taxpayer after that date. Certain exceptions were provided in the case of property constructed (reconstructed or erected) or acquired under a binding contract entered into on or before April 18, 1969. Where property qualified for the credit because of the binding contract or other transition rules, a full credit would be available if the property was placed in service prior to January 1, 1975.

With respect to carryforward provisions, the 1969 Act restricted the amount of unused credits which a taxpayer could claim as carryovers in any one year after 1968 to 20 percent of the aggregate amount of unused credits otherwise available as a carryover. An additional three-year carryforward was provided for unused credits which were limited by reason of the 20-percent limitation. These limitations were in addition to the 50-percent limitation of the credit provided for in the 1966 Act. However, the use of the additional three-year carryforward was subject to the 50-percent and 20-percent limitations.

Revenue Act of 1971.—The 1971 Act restored the 7-percent credit with certain modifications. Useful lives were shortened by one year per bracket: i.e., property with a useful life of three to five years (previously four to six years) qualified for the credit to the extent of one-third of its cost; property with a useful life of five to seven years (previously six to eight years) qualified for the credit to the extent of two-thirds of cost; and property with a useful life of seven years or more (previously eight years or more) qualified for the full credit. A conforming amendment was adopted with regard to recapture of the credit for aircraft leased for use outside the United States to allow the use of the credit for aircraft in foreign use if it did not exceed three to five years. Conformity between the useful life used for the credit and that used for depreciation or amortization was required by statute.

Previously, the credit was generally available to "section 38" property, wherever it had been produced. In view of balance-of-payment difficulties, the credit was made temporarily unavailable for foreign-produced property. This limitation expired December 19, 1971.

Certain clarifications in the definition of "section 38" property were provided. Buildings and their structural components have never qualified for the credit. Storage facilities used in connection with manufacturing, production, extraction or the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services, however, were made eligible as an exception.

In addition, certain exceptions were provided to extend the investment credit to submarine telephone cables, coin-operated machines (vending, washing, or drying) in lodging facilities, certain aspects of the telephone service of the Communications Satellite Corporation (COMSAT), certain drilling equipment used for the purpose of exploring for, developing, or transporting resources from the Outer Continental Shelf, livestock (except horses and livestock bought under rules analogous to "wash" sales of stock or securities), motion picture and television films, and certain railroad equipment.

Regulated utility companies had previously had a three-percent investment credit. The 1971 Act provided a four-percent credit for public utility property. Also, the 1971 Act provided that property used predominantly in furnishing or selling of all communication services (other than international telegraph services) was to receive a four-percent credit. Thus, the property used in miscellaneous types of regulated communication services, such as data transmission operations, was to receive the four-percent rather than the 7-percent credit.

The 1969 Act had imposed a 20-percent limitation on certain carryovers; the 1971 Act provided that this 20-percent limitation would not apply with respect to the proportion of the year after August 15, 1971. Also, the 1971 Act provided that carryovers of unused credits from 1970 and earlier years, to the extent they have not previously expired, would be allowed a 10-year rather than 7-year carryforward. With respect to certain exceptions to the recapture rules for casualties, thefts, and other dispositions, the 1971 Act eliminated the exceptions provided in the 1969 Act. With regard to the availability of the credit to certain lessors, the 1971 Act limited the availability of the credit: (1) if property, which is the subject matter of a lease, was manufactured or produced by the lessor, the credit would be available, or (2) if the leasing activity constitutes a business activity of the taxpayer, the credit would be available.

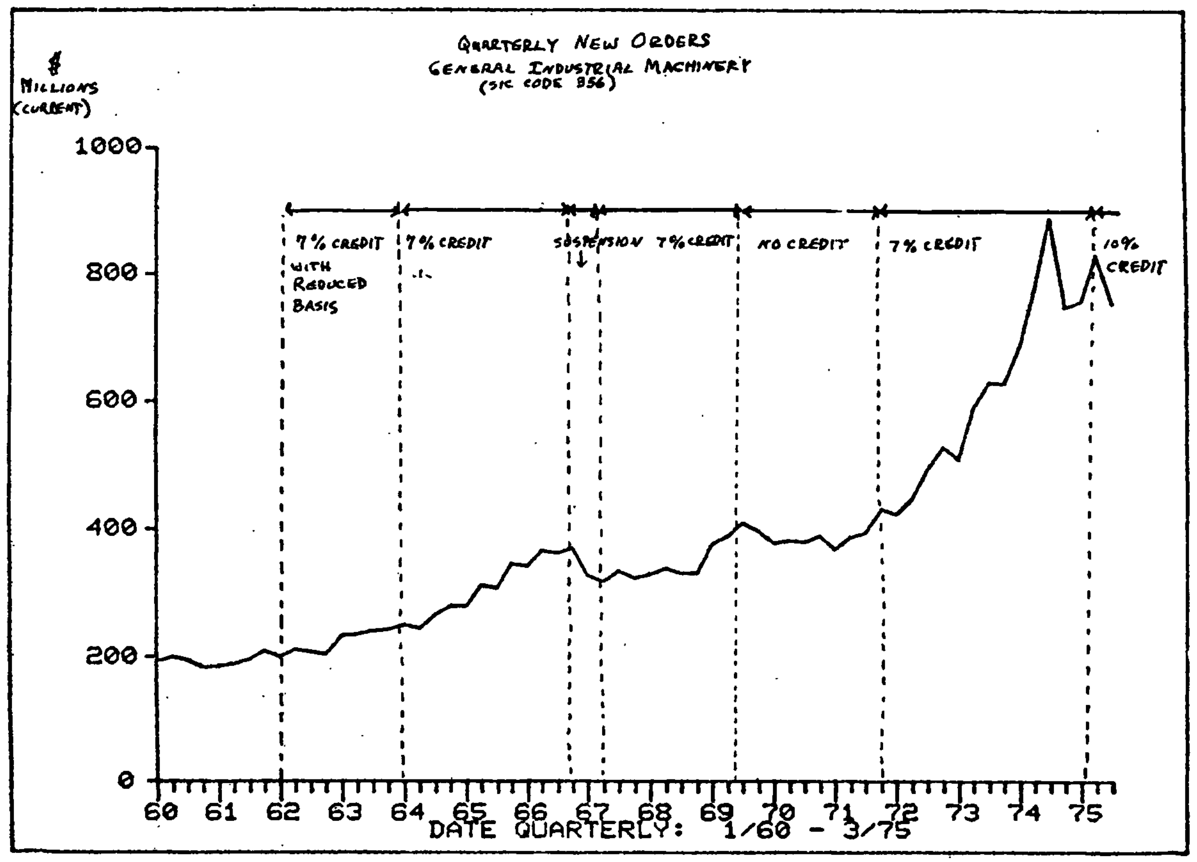
Tax Reduction Act of 1975.—The Tax Reduction Act of 1975 increased the rate of the investment tax credit for all taxpayers (including public utilities) to 10 percent from 7 percent (from 4 percent in the case of certain public utilities) for the period beginning January 22, 1975, and ending December 31, 1976. In the case of a corporate taxpayer, a taxpayer may elect an 11-percent credit during this period if an amount equal to one percent of the qualified investment is contributed to an employee stock ownership plan. Also, in the case of public utilities, the limitation on the amount of tax liability that may be offset by the investment tax credit in a year is increased from 50 percent to 100 percent for the two-year period and then is gradually reduced back to the 50-percent level over a five-year period. In addition, the limitation on qualified investment in used property was increased to $100,000 from $50,000 for the period beginning January 23, 1975 and ending January 1, 1977. The Act also provided that the credit could be taken when progress expenditures are made, even before the property is placed in service.

Issues

As noted above, the investment credit has just been increased from 7 percent to 10 percent until the end of 1976. The objective of the increase was to increase capital investments in plant and equipment in a manner that would complement the stimulus provided to consumer spending. Expenditures and plant and equipment remain low and have fallen in real terms. Another problem is the large amounts of unused capacity in most industries. Business may accordingly be hesitant in view of this unused capacity to plan significant new outlays for plant and equipment. However, there usually appears to be a lag in the impact of the investment credit. Thus, the effects of the 1975 Act may yet be realized in ensuing months. Also, while the effects of the credit may be modest so far this year, it may be that in the absence of the credit, real investment would have fallen even further. There are a number of issues with regard to the investment credit which the committee may wish to consider.

Effectiveness of the investment credit.—There is some disagreement among economists about the effectiveness of the investment credit as a stimulus to investment. In part, this disagreement stems from the difficulties of isolating the particular cause of an increase in investment at a particular phase of the business cycle. At the trough of a recession, interest rates tend generally to be low, and more favorable financing in part explains why investment usually rises during a recovery. Also, as the economy begins to recover from a recession, corporate profits usually rebound as a result of higher worker productivity levels. Improved internal cash flow will also then increase investment.

Diagram 1 displays quarterly new orders for general industrial machinery over the period 1962–1975. Quarterly new orders grew rapidly in the fourth quarter of 1962 and then rather modestly in 1963. After liberalization in 1964, new orders grew more rapidly. The short period of suspension of the credit evidenced a rapid decline of new orders in the last quarter of 1966. Reinstatement of the credit seems to have halted the decline, although it was not until late 1968 that new orders for general industrial equipment grew rapidly again. Repeal of the credit in 1969 witnessed a drop in quarterly orders until 1971. New orders rose for the first three quarters of 1971. Of interest is the apparent short decline in new orders after the effective date of the 1971 credit. This may reflect the possibility that business delayed new investment until the credit was enacted; even though its effective date was made retroactive. The early experience in 1975 may parallel the 1971 experience.



QUARTERLY NEW ORDERS
GENERAL INDUSTRIAL MACHINERY
(SIC CODE 356)
$
MILLIONS
(CURRENT)
1000
800
600
400
200
0
7% CREDIT WITH REDUCED BASIS
7% CREDIT
SUSPENSION
7% CREDIT
NO CREDIT
7% CREDIT
10% CREDIT
60 61 62 63 64 65 66 67 68 69 70 71 72 73 74 75
DATE QUARTERLY: 1/60 - 3/75

Compositional aspects of the credit.—Provision of the investment credit not only may affect the aggregate level of investment, but also in certain circumstances the composition of investment as well. As the credit increases the return on investment, it alters choices for certain goods in the economy that will not, in general, benefit from the credit. For example, the credit may induce business to switch from investment in structures, which do not qualify for the credit, to investment in machinery and equipment which does qualify.

Another compositional aspect of the credit involves its utilization by different industries. The overall objective of the credit is to stimulate investment. A related objective may be to stimulate investment in those areas of the economy that are particularly depressed or those areas where subsequent bottlenecks due to capacity limitations are envisioned. If this second objective is to be pursued, the committee may wish to consider, and the possibility of providing differential credits across industries.

Timing of credit.—Periodic review of the investment credit can create uncertainty in the business community which in turn can adversely affect the impact of the credit. If business correctly anticipates the direction of the change in the credit, substantial tax advantages may be realized. In the past 13 years, 7 decisions (approximately one every two years) have been made which have altered the provisions of the credit. Such alterations have been in response to changing economic needs to moderate or expand investment. However, to the extent such corrective action is in response to an economic problem, final action when coupled with the lagged "multiplier" effects of the credit may not provide the remedial action necessary, but rather create excessive stimulus to investment demand. Our current position in the recovery may typify such a situation. There is evidence that the recovery in the third and fourth quarters of 1975 will be reasonably strong. It would seem likely to expect that the current provision of the 10-percent credit in 1976 coupled with rising aggregate demand should encourage substantial new levels of investment. The steel industry has already announced new investment plans for next year.

Alternatives to current temporary increase in investment credit.—There are a number of alternatives to the current temporary increase in the investment credit. For example, the committee may wish to consider the possibility of having a nonpartisan agency forecast where investment is likely to be needed and to certify which industries would be eligible for an additional credit, perhaps subject to congressional veto. Or, the committee may wish to consider the elimination of the double taxation of corporate income, or a further reduction in the corporate rates. In addition, the committee may wish to consider modifying the current temporary increase in the investment credit by raising or lowering the rate of the credit, altering the definition of qualified investment, changing the current 50-percent limitation, or changing the 3-year carryback and 7-year carryforward procedure.

Alternative Proposals

Mr. Ullman

He would continue the investment credit at the temporary 10-percent rate and the increase in the used property limitation to $100,000 for three additional years; that is, through December 31, 1979.

Messrs. Waggonner and Conable

The proposal would make the following revisions: (1) increase the investment tax credit to a permanent rate of 12 percent effective January 1, 1976; (2) allow the full credit for any asset having a 3-year life or longer; (3) allow the full amount of the credit to be taken each year without regard to any income limitation; and (4) allow any amount of credit in excess of tax liability of the taxpayers for a year to be refunded.

Mr. Karth

The proposal would provide for an extension of the 10-percent rate for the investment credit beyond the end of 1976.

Messrs. Pickle, Jones, Schneebeli, Duncan, and Martin

The proposal would provide for a permanent 10-percent rate for the investment tax credit at the end of 1976.

Mr. Archer

The proposal would provide for a permanent increase in the investment tax credit rate to 12 percent or possibly 15 percent.

Messrs. Burleson, Jones, Duncan, Crane, Martin, and Ketchum

The proposal would provide for a refund for investment credits which have been earned but which are unused at the end of the carryover period and otherwise would be lost. Mr. Jones would do so if the current investment tax credit is not extended.

Mr. Duncan

He would give consideration to increasing the investment credit and removing the time limitation for the use of the credit.

B. Investment Credit in the Case of Movie and Television Films

Present law

Under present law, taxpayers are entitled to receive an investment credit for tangible personal property (i.e., section 38 property) which is placed in service by the taxpayer. Currently, the credit is allowed at a 10-percent rate, but under present law this rate is scheduled to be reduced to 7 percent beginning in 1977. In order to receive the full (7 percent or 10 percent) credit, the property placed in service by the taxpayer must have a useful life of at least 7 years. If the property has a useful life of at least 5 years (but less than 7 years) the taxpayer is entitled to two-thirds of the full credit. If the property has a useful life of at least 3 years (but less than 5 years) the taxpayer is entitled to a one-third credit. In addition, there cannot be any predominant foreign use of the property during any taxable year, or the property will cease to qualify as section 38 property.

Prior to 1971, it was not clear whether (and if so, under what conditions) the investment credit was available for movie or television films. A court case held that movie films were tangible personal property eligible for the investment credit. In the Revenue Act of 1971, it was made clear that motion pictures and television films are to be treated as tangible personal property which is eligible for the investment credit (i.e., section 38 property). However, there still are a number of unsettled issues, such as how to determine the useful life of a film (particularly for years prior to 1971), the basis on which the credit is to be computed, and how to determine whether there has been a predominant foreign use of the film.

Problem

Due to the uncertainties of present law with respect to the questions of useful life and predominant foreign use, it is often difficult to determine whether a film is entitled to a full (7 percent) credit, a partial one-third or two-thirds credit, or, possibly to no credit. It is obviously desirable to clear up these issues, in order to avoid costly litigation with respect to the past, and to allow accurate investment planning for the movie industry in future years.

In addition, since the major purpose of the investment credit is to create jobs in the United States, it might be desirable to provide that for the future the amount of the investment credit in the case of movie films will depend on the place of production of the film (i.e., United States or foreign), rather than on the place where revenues are received for showing the film. Thus, under the 1974 committee bill (discussed below), the foreign use test would not apply to movie films for the future. Taxpayers could take a two-thirds credit on all their films (regardless of the useful life of particular films), or they could elect to determine useful life on a film-by-film basis, and, under this method of computing the credit, the useful life of the film would be treated as having ended when 90 percent of the basis of the film has been recovered through depreciation. As a further incentive to encourage U.S. production of films, the 1974 committee bill provides that where 80 percent or more of the direct production costs of the film are U.S. costs, the credit base for the film will include certain indirect costs (such as general overhead costs, the cost of screen rights, etc.), but otherwise the credit base will be limited to direct U.S. production costs.

One technical problem, under the 1974 committee bill, is that the investment credit is to be available to the person who bears the risk of loss with respect to the film. It is desirable that the rules with respect to who is entitled to the credit should be as simple and clear as possible, both to facilitate the administration of the law (as well as tax planning by private parties), and to minimize the possibility that the Treasury may be placed in a "whipsaw" position where several taxpayers might receive the credit for the same film.

At the same time, it is desirable that the test should be as consistent as possible with standards which courts have applied in the past in determining the ownership of films for tax purposes, in part because taxpayers may have relied on these principles in planning their past investments, and in part to ensure that the rules with respect to ownership of films are as consistent as possible for purposes of depreciation and the investment credit.

Also as part of the litigating compromise which the committee attempted to achieve under the 40-percent method, the 1974 committe bill provides that if a taxpayer elects to use this method for any period, unused credits earned by use of this method cannot be carried forward to any year when the two-thirds method is in use (and, in any event, under the committee bill there can be no carryover to any taxable year beginning after December 31, 1974, regardless of what method the taxpayer uses for those years).

The argument for this approach is that, from the standpoint of the Treasury, the 40-percent method represents a fair settlement to the industry (particularly with respect to pre-1971 credits) and should not be used to generate large carryovers which can be used in post-1975 years.

The principal argument against this approach is that because of the varying profit and loss situations of different film producers in recent years, the credit carryover restriction bears more heavily on some members of the industry than on others (the staff has been informed that at least several members of the industry are affected to a significant extent).

Alternative Proposals

1974 committee bill

Last year, the committee decided to provide different methods to deal with the problems of the proper treatment of the investment credit for motion pictures and television films for the past and for the future. For the past, one of two alternatives would be available. A taxpayer under the first method (in most respects the IRS litigation position) would be eligible to receive the full credit (or any partial credit) for their films if it is demonstrated on a film-by-film basis that the film satisfied both the useful life requirement and the requirement that there must be no predominant foreign use. The useful life of the film is to be treated as ending at the end of the first year in which for depreciation purposes it was estimated that 90 percent or more of the depreciable cost of the film would be recovered. A film is to be treated as used predominantly in foreign markets if, in any year (and not on a cumulative basis), more than 50 percent of the gross revenues from the film resulted from showing the film abroad.

A second alternative method may be elected by a taxpayer for all open years prior to 1975 (for which an investment credit was available) or only for years prior to the reenactment of the investment credit on August 15, 1971. Unused investment credits may not be carried over from years in which this method is used to any subsequent years. Under this second alternative, a taxpayer may elect to take an investment credit on the basis of 40 percent of the cost of all of his films without regard to the estimated useful life of the film and also without regard to whether the film is shown predominantly outside of the United States. The credit would be based on the total costs of production, including capitalized production costs, a reasonable allocation of general overhead costs, salaries paid to the actors and production crew, costs of "first" distribution of prints, and the cost of the story being filmed. The cost for this purpose would include so-called residuals, but in the case of participations with respect to actors or others, it would include only those which are guaranteed. Films such as news features which are essentially transitory in nature, as well as films which are produced and shown exclusively in foreign countries, would not be eligible for the credit.

In addition, any taxpayer who has received final judgment on his entitlement to the investment credit for any prior year may elect to have his right to the investment credit for all years beginning prior to January 1, 1975, determined under present law, as interpreted by the courts, rather than by any of the alternatives set forth above.

For future years, taxpayers could elect to take an investment credit on a two-thirds basis for all films (instead of determining useful life on a film-by-film basis). The availability of the investment credit in this case would not depend on whether the film was predominantly used within the United States or in foreign countries; instead, it would depend on where the film is produced, rather than where receipts are derived from the showing of the film. Films, such as news features, which are essentially transitory in nature, would not be included in the base on which the two-thirds credit is computed.

If 80 percent or more of the direct production costs of a film are incurred in the United States, a taxpayer would be entitled to an investment credit on the same credit base as indicated above under the 40-percent method with respect to prior years, except that the credit base would not include direct expenses for foreign production or for salaries paid for services performed abroad (unless the salaries were paid to U.S. persons and were subject to U.S. tax). In determining whether this 80-percent test is met, only direct costs of production would be taken into account. (Overhead costs and the costs of screen rights, for example, would not be taken into account.)

If less than 80 percent of the production costs are incurred for U.S. production, a taxpayer could still receive a credit to the extent of *direct* U.S. production costs. The credit base in this case would not include such items as general overhead costs or cost of acquiring screen rights or any costs of foreign production except for salaries paid to U.S. persons subject to U.S. tax.

This two-thirds method may also be elected by taxpayers for all of their section 50 property (generally property placed in service after August 15, 1971).

The committee also agreed that the investment credit should be available in the case of films to the persons who bear the risk of loss if the film is not a successful picture. This rule applies under any of the alternatives set forth above.

Messrs. Corman and Pickle

Mr. Corman proposes the same provision as agreed to by the committee last year in the 1974 committee bill. Another possible modification of the 1974 committee bill would be to eliminate the restriction on carryovers, in the case of taxpayers who elect to use the 40-percent method for prior years. Mr. Pickle would allow the investment tax credit for movies made before 1971 by allowing 40 percent of the credit to be taken.

C. Electric Utilities

Problem

The electric utilities industry faces several problems that reflect its unique role in the economy. Among major industries, electric utilities are the most capital intensive per dollar of revenue raised. The rapid increase in oil and coal prices has substantially increased the operating expenses of electric utilities. Because the industry is regulated, those utilities that are not allowed to pass on increased fuel costs automatically have experienced substantial lags recouping those increased costs through increased rates. In addition, high interest rates, reflecting in part the deteriorating financial position of the utilities and in part increased expectations of long-term inflation, have adversely affected the utilities industry by increasing their costs and pushing some utilities to the maximum debt-equity ratio allowed by State law. However, consumers and regulatory bodies have strongly resisted the increased rates necessary to reflect these higher costs if current investment plans are to be maintained. As a consequence, the financial stability of these utilities has been adversely affected.

As the pace of inflation moderates, the regulatory process may be able to allow appropriate rate increases on a more timely basis. Overhaul of the regulatory process is occurring in many States, as well as innovations in such operating procedures as peak-load pricing. In the meantime, however, there has been a substantial deferral of new investment in nuclear and coal-powered generating plants, which may result in capacity limitations in the foreseeable future.

In response to these unique problems faced by public utilities, the Tax Reduction Act of 1975 included specific provisions to stimulate additional investment. The investment credit in public utilities (including gas and telephone utilities as well as electric utilities), which previously had been at only 4 percent instead of the 7 percent allowed other businesses, was increased to 10 percent. Also, the limitation on the amount of tax liability which the credit may offset was increased for these utilities from 50 percent to 100 percent for the period beginning January 22, 1975, and ending December 31, 1976. This limitation is to be reduced gradually to 50 percent over the five-year period from 1977 to 1982.

Administration Proposals

The Administration has made two related proposals with respect to electric utilities which were originally recommended by the President's Labor-Management Committee. The first provides for the deferral of tax on dividends paid by electric utilities to shareholders who elect to take additional stock in lieu of a cash dividend. The second provides for certain modifications in the investment credit and amortization rules.

1. Dividend reinvestment

Under present law (sec. 305(a)), a pro rata stock dividend is not taxable to a shareholder at the time he receives it, but is taxable only when he sells or otherwise disposes of the shares received as a dividend. Any gain on the sale is treated as a long-term capital gain if the underlying shares (on which the dividend was declared) were held for more than six months.

Stock dividends which are not pro rata, including stock dividends received pursuant to a shareholder's option to receive either stock or cash, are taxable at fair market value when the shares are initially received. The rationale for this different treatment is that with pro rata stock dividends no shareholder has gained any increased interest in the corporation since all shareholders receive a proportionately equal amount of additional stock. But with non-pro rata dividends those receiving the stock dividend do gain an additional interest in the corporation relative to those not receiving stock. Thus, shareholders receiving the stock have gained some value, which is taxed as a dividend.

The Administration proposal would permit a shareholder of a regulated public utility to postpone the tax on dividends paid by the utility by electing to take additional stock of the utility in lieu of a cash dividend. The additional shares received under this election would not be taxed to the shareholder when he receives them, but would be taxed as ordinary income when the shareholder sells part or all of his stock in the utility. (Dividend stock is to be treated as sold before any other stock.) The proposal would apply only to stock distributions made after the date of enactment and before January 1, 1981.

Analysis.—By some recent estimates, over 200 dividend-paying corporations (utilities and nonutilities) have taxable dividend reinvestment plans now in operation. These generally include one of two types of reinvestment mechanisms. Under the first type, a bank acts as agent for participating shareholders and collects the cash dividends. The dividends are pooled, and shares are bought on the open market. Since the bank is purchasing already outstanding shares held by other shareholders, no additional capital flows to the utility.

Under the second type of plan, the company issues new shares of stock for the reinvested amounts. American Telephone and Telegraph Company is the leading user of the second type of plan, which raises additional capital for the company.

Those who argue in favor of a dividend reinvestment scheme for electric utilities base their argument on the fact that these utilities have not in the recent past been able to sell new issues of stock because of the current depressed prices for public utility stocks. In addition, many of these utilities have increased their debt obligations to the maximum extent permitted by State regulatory authorities. If these utilities are to raise additional capital needed for expansion, it is argued that they must retain most of their annual earnings. However, public utilities generally cannot eliminate or significantly reduce their cash dividends because many of their shareholders rely on these dividends for income for living expenses, even though other shareholders would be willing to reinvest their dividends if some incentive were provided. Thus, it is argued that a tax-free dividend reinvestment plan would allow these utilities to retain for additional a significant portion of their annual earnings which otherwise would have to be paid in dividends, while still allowing those who need cash dividends to receive them. Although no one can say with certainty how many investors would elect to reinvest their dividends if they could be reinvested tax-free, some industry officials have estimated that as much as 20 or 25 percent of electric utility shareholders might elect the stock dividends.

It is also argued that dividend reinvestment programs will make the stocks of electric utility companies more appealing to other investors who normally invest in growth stocks (i.e., those investors not concerned with receiving dividend income) since reinvesting the dividends tax-free would result in a growth in the value of the investor's stockholdings. In this way, electric utilities might be better able to attract additional investors to purchase their stocks.

On the other hand, those who argue against a tax-free dividend reinvestment provision point out that the tax law has provided that stock dividends received non-pro rata among shareholders (including stock received under a cash-or-stock election by shareholders) are to be taxed to the shareholder at the time of receipt since before the adoption of the 1954 Code (the rule was broadened significantly in the Tax Reform Act of 1969). This provision is a long-accepted rule of tax policy. Providing an exception for electric utilities would thus provide a special benefit to these companies which probably should be adopted or not adopted for all corporations generally. The proposed exception would clearly be a tax expenditure item for electric utilities.

Any dividend reinvestment planned for electric utilities would contain some administrative difficulties for the Internal Revenue Service. The amount of dividend tax deferred upon receipt of the stock dividend could, for example, be paid when that shareholder first sells stock in that company. At the time of the sale the Internal Revenue Service might have difficulties in determining whether or not in some prior year a taxpayer had received a stock dividend under a reinvestment plan which should lead to ordinary income of some amount. Particularly if the sale takes place many years after receipt of the stock, the difficulty in determining whether any amount is to be reported as ordinary income and, if so, how much, could be great. This problem is aggravated in the case of gifts of the stock, since under the Administration proposal the ordinary income tax is deferred until the donee sells the stock.

Another special problem arises in adopting any dividend reinvestment plan because of the fact that many electric utility companies are owned by public utility holding companies. However, under the Public Utility Holding Company Act of 1935 these holding companies are generally permitted to own only operating electric utility companies and not other types of businesses. Thus the problems of dealing with a holding company structure may not be substantial if the committee limits the dividend reinvestment plan only to dividends of a public utility holding company which are received from an operating electric utility and which are reinvested in a electric utility company. In this way, the shareholders of the holding company would not receive any tax benefit not available to direct investors in an operating electric utility.

If the committee decides that this special treatment for electric utilities is justified given the economic conditions these companies face, the committee may also wish to consider a special provision placing a dollar limit (such as $500 per year) on how much any taxpayer can receive in tax-free reinvested stock dividends in any year.

2. Investment credit.

The administration has also proposed increasing the investment credit to 12 percent for expenditures for the construction of additional facilities (other than power plans fired by oil or gas) by electric utilities. The increase in credit is available only if construction work in progress is included in the utility's rate base and the benefit of the increase is reflected for ratemaking purposes *pro rata* over the life of the asset which generates the benefit, instead of recognizing the entire tax benefit in the year the utility's taxes are actually reduced.

Additionally, the administration proposes that the full credit be available on progress payments for the construction of electric utility property that takes two years or more to build, except electric generating facilities fueled by petroleum products, without regard to the 5-year phasein requirement of the Tax Reduction Act of 1975. This provision is to apply only if the regulatory agency includes construction work in progress in the utility's rate base for ratemaking purposes.

Other related provisions of the proposal involve an extension to January 1, 1981, of the period during which pollution control facilities installed in a pre-1969 plant or facility may qualify for rapid 5-year straight-line amortization in lieu of normal depreciation and the investment credit. Also, it is proposed to permit 5-year amortization of the cost of either converting or replacing a facility fueled by petroleum products to one fueled by nonpetroleum products.

Analysis.—While the economic difficulties facing the electric utility industry are severe, the Congress acted in the Tax Reduction Act of 1975 to ease their burden by more than doubling the investment credit rate for these companies and by raising the 50 percent of tax liability limitation to 100 percent. In connection with energy legislation earlier this year, the committee also considered allowing 5-year amortization (which in many cases has an impact similar to allowing an increased investment credit reflected for ratemaking purposes over the life of the equipment) for new equipment for the conversion or replacement of generating facilities fueled by petroleum products. At that time the committee decided against allowing the tax-free reinvestment treatment. Instead, the committee agreed to eliminate the existing 10-percent investment credit for new electric generating equipment in facilities which use petroleum products as a fuel (subject to several transitional provisions).

If the committee decides that electric utilities need some tax stimulus for further investment, the committee may wish to reconsider its earlier decisions. An increased investment credit (or rapid amortization) would provide for a somewhat higher level of earnings for profitable utilities, which earnings could be plowed back into increased investment. Further, the higher earnings, if significant, may aid these companies in attracting new investors for their stocks. Those utilities not making profits would, of course, not receive any immediate benefit from these provisions.

However, the question arises whether providing a credit greater than that available in other sectors of the economy may not result in ultimate overexpansion in the long-run supply of electric generating facilities. If such a credit were provided for a limited time, this long run consideration would appear to be less important. Also, to the extent normal profitability returns to the electric utility industry, the previous problem of "passthrough" of the benefits of the credit to the customers in the form of lower rates may recur. In such circumstances, there may be an issue as to the appropriateness of, in effect, relieving State regulatory authorities of their responsibilities for allowing adequate rates.

D. Capital Cost Recovery

Present Law

Depreciation Allowances

Under present law, a taxpayer is permitted to claim depreciation allowances for certain property used in his trade or business or held for the production of income under any of the following methods:

(1) The straight-line method of depreciation results in an equal annual expense charge for depreciation over an asset's useful life. For purposes of computation, the straight-line rate is determined by a fraction, the numerator of which is one and the denominator of which is the estimated useful life of the asset.

(2) The 200-percent declining balance method of depreciation, more commonly referred to as double-declining balance, allows a rate equal to twice the straight-line rate. The declining balance rate is applied to the unrecovered cost, i.e., cost less accumulated deprication for prior taxable years. Since the depreciation base is reduced to reflect prior depreciation, the amount claimed as depreciation is greater in earlier years and declines in each succeeding year of an asset's useful life.

(3) The sum of the years' digits method of depreciation is computed using a fraction the numerator of which is the years' digits in inverse order and the denominator of which is the sum of the numbers of years. For example, if an asset has an estimated useful life of 10 years, the denominator is the sum of one plus 2 plus 3, etc., plus 10, or 55. The numerator would be 10 in the first year, 9 in the second year, etc. Thus, in the first year, the fraction would be 10/55, in the second year 9/55, etc. As in the case of the declining balance method, the annual depreciation is greater in earlier years and declines in each succeeding year of an asset's useful life.

(4) Any other consistent method producing an annual depreciation allowance, which, when added to all allowances for the period beginning with the taxpayer's use of the property (including the taxable year), does not exceed the total depreciation allowances which would have been taken during the first two-thirds of the useful life of the property had the double declining balance method been used.

Taxpayers were first given the option of using the double declining balance method and the sum-of-the-years-digits method by the 1954 Internal Revenue Code. Both of these methods are accelerated depreciation in that they permit the taxpayer to take relatively large depreciation methods deductions in the early years of the asset's use and lower depreciation in the later years. This is generally advantageous to the taxpayer since an accelerated method of depreciation permits him to recover his capital costs more quickly than the straight-line method of depreciation.

The 1969 Tax Reform Act limited the use of rapid depreciation methods in the case of certain real estate because the use of these methods made it possible for taxpayers to deduct amounts in excess of those required to service the mortgage during the early life of the property. Also, because accelerated depreciation usually produced a deduction in excess of the actual decline in the usefulness of the property, economically profitable real estate operations were normally converted into substantial tax losses, sheltering from income tax economic profits and

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permitting avoidance of income tax on the owner's other ordinary income, such as salary and dividends. Under the 1969 Act, new residential housing continued to be eligible for the double declining balance or sum-of-the-years-digits depreciation methods. However, new construction other than residential housing was limited to 150 percent declining balance depreciation. To eliminate incentives for the repeated sale and resale of property for purposes of tax minimization, used realty (other than used residential property) acquired after July 24, 1969, was generally limited to straight-line or a comparable, ratable method of depreciation. Used residential property with a useful life of 20 years or more, acquired after July 24, 1969, was limited to 125 percent declining balance depreciation.

Present law also allows taxpayers acquiring personal property for use in a trade or business or for the production of income, an additional first year depreciation allowance amounting to 20 percent of the cost of the property. This extra first-year allowance applies only to the first $10,000 of the cost of property ($20,000 on a joint return) placed in service in a taxable year.

The depreciation allowances that are taken in a specific case depend in large measure on the useful life of the asset. Before 1962, business firms depreciated their property in terms of useful lives that were established for several thousand different classifications of assets (so-called Bulletin "F" lives). The guideline lives for depreciable assets that were put into effect in 1962 consolidated assets into about 75 broad asset classes and also shortened prescribed lives by up to 30 or 40 percent. The 1962 guidelines also established the use of industry classifications as distinct from classifications by type of assets.

The lives selected for use under the guidelines were determined by reference to the useful lives claimed by the taxpayers surveyed. Generally, the lives selected were the useful lives being claimed by taxpayers at the thirtieth percentile—that is, 29 percent of the assets had shorter lives and 70 percent had longer lives.

The guidelines also contained a reserve ratio test which was designed to assure that taxpayers would not be permitted continually to depreciate their assets over a period of time substantially shorter than the period of actual use. Basically, the reserve ratio test assumed that the actual useful life of assets could be determined by comparing the amount of depreciation reserves to the acquisition costs of the assets being depreciated. This comparison was known as the reserve ratio test. A built-in tolerance was contained in the reserve ratio test to assure that the test would be met in the cases of taxpayers depreciating their assets at a rate not more than 20 percent faster than the period of their actual use of such assets.

The application of the reserve ratio test was initially suspended for three years. In 1965, the reserve ratio test was substantially modified and new transitional rules were added which had the effect of further delaying the application of the test, in most cases, until about 1971. When the Treasury Department adopted its asset depreciation range system ("ADR") in early 1971, it completely eliminated the reserve ratio test for 1971 and future years.

The Revenue Act of 1971 enacted into law the ADR system with certain modifications. Under this Act, the Internal Revenue Service may permit depreciation lives within the range of 20 percent above or below the class life where taxpayers elect to use the ADR system. The Act also provides a unified system of class lives which may be elected by taxpayers for assets placed in service after 1970.

Rapid 5-year amortization

In the Tax Reform Act of 1969, four provisions were enacted to make available a special 5-year amortization as an incentive to make certain investments. The types of investment made eligible for rapid amortization include (1) rehabilitation of low and moderate income housing, (2) pollution control facilities, (3) railroad rolling stock, and (4) certain coal mine safety equipment.

In general, rapid amortization was made available as an alternative to the investment tax credit that was repealed in the 1969 Act. Each of the types of investment eligible for rapid amortization was considered important to the success of an existing social policy. Those programs relied entirely or partially upon private investment in order to accomplish their objectives, and Congress believed that an additional investment incentive restricted to these activities should be made available in lieu of the investment credit. When the investment credit was reenacted in 1971, Congress specifically provided that the investment credit and rapid amortization both would not be available for the same investment. A taxpayer may elect either the investment credit or rapid amortization.

These four amortization provisions are summarized, as follows:

(1) *Rehabilitation of low and moderate income rental housing (sec. 167(k)).*—Taxpayers may elect to compute depreciation on rehabilitation expenditures incurred after July 24, 1969, on low and moderate income rental housing under the straight line method over a period of 60 months, if the additions or improvements have a useful life of 5 years or more. This rapid amortization is available only for low-income rental housing where the dwelling units are held for occupancy by families or individuals of low or moderate income, consistent with the policies of the Housing and Urban Development Act of 1968. The 60-month rule does not apply to hotels, motels, inns, or other establishments, where more than one-half of the units are used on a transient basis.

Only the aggregate rehabilitation expenditures as to any housing which do not exceed $15,000 per dwelling unit qualify for the 60-month depreciation. In addition, for 60-month depreciation to be available the sum of the rehabilitation expenditures for two consecutive taxable years—including the taxable year—must exceed $3,000 per dwelling unit.

(2) *Pollution control facilities (sec. 169).*—Taxpayers may elect to amortize the first 15 years of the useful life of a certified pollution control facility over a period of 60 months. The amortization deduction is limited to pollution control facilities added to plants (or other properties) which were in operation before January 1, 1969. Thus, the special amortization provision was not made available in the case of

facilities included in new plants built after 1968. Amortization is available for the first 15 years of the normal useful life of a pollution control unit. For example, where the useful life of a unit normally is longer than 15 years, say 25 years, the first 15 years (or 60 percent of the total cost of the facility) could be treated as a separate property and amortized over 5 years. The remaining 10 years of useful life (40 percent of the total cost) could be treated as a second property with a 25-year normal useful life and depreciated under currently applicable regulations.

Eligible equipment has to be certified as a pollution control facility to the Secretary of the Treasury by the appropriate Federal and State authorities. Each facility, moreover, must be a separate, identifiable treatment facility used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing or storing of pollutants, contaminants, waste or heat. Facilities that only diffuse pollution, rather than abate it, are not pollution control facilities.

(*3*) *Railroad rolling stock* (*sec. 184*).—Specified classes of rolling stock are eligible for rapid amortization over 5 years, if the original use by the taxpayer is after December 31, 1968. The provision is available for the rolling stock of all domestic railroads, switching or terminal companies which are wholly owned by domestic railroads, and companies 95 percent or more of whose stock is owned by one or more railroads. Rapid amortization also is available to lessors for rolling stock leased to a domestic railroad or railroad company.

(*4*) *Coal mine safety equipment* (*sec. 187*).—Taxpayers may elect to amortize over a 5-year period certified coal mine safety equipment. For this purpose, certified coal mine safety equipment means electrical face equipment which is (a) required in order to comply with the Federal Coal Mine Health and Safety Act of 1939, (b) is certified as permissible under that Act by the Secretary of Interior, and, (c) placed in service before January 1, 1976.

The equipment covered by this provision is designed to prevent sparking of coal mine equipment. When sparking occurs in coal mines with a sufficient concentration of methane gas, it can cause ignitions and explosions. This provision was enacted to ease the cost burden on operators of so-called nongassy mines who were required to install this safe electrical face equipment under the Federal Coal Mine Health and Safety Act of 1969.

The 1969 Act provided that all four of these special amortization provisions were to be applicable only for a 5-year period which expired at the end of 1974. Legislation adopted at the end of 1974 extended these four amortization provisions for one additional year through December 31, 1975, in order to provide additional time for consideration of the provisions in a subsequent tax reform bill. Subsequent legislation extended the 5-year amortization provision for low income housing through the end of 1977 with respect to expenditures incurred pursuant to a binding contract entered into before December 31, 1974.

(*5*) *On-the-job training and child care facilities* (*sec. 188*).—Five-year amortization was provided in the Revenue Act of 1971 for the capital cost incurred for property used for an on-the-job training facility for employees or prospective employees or as a child care center facility primarily for the children of employees. This provision applies to expenditures for these purposes made during the period from January 1, 1972, through December 31, 1976.

The Energy Conservation and Conversion Act of 1975 (H.R. 6860), as passed by the House, would extend 5-year amortization for certain railroad equipment and rolling stock for the period 1975 through 1979. This bill also provides 5-year amortization for waste burning and recycling equipment, solar energy equipment (if no investment credit is claimed), coal slurry pipelines, oil shale conversion equipment, coal gasification and liquefaction facilities, and equipment used in deep mining coal with respect to equipment placed in service from the period March 18, 1975, through December 31, 1980. This legislation is now being considered by the Senate Finance Committee.

Issues

Different views regarding present depreciation allowances

At the present time, there appears to be considerable controversy about the adequacy of capital recovery allowances. There is a considerable body of opinion that holds that present capital recovery allowances are not adequate and interfere with the efficient operation of the economy. Others, however, maintain that capital recovery allowances are already over-generous in a number of respects, they maintain that these expressively generous allowances permit some business taxpayers to secure undue tax advantages and provide inducements for the creation of numerous tax shelter devices.

In general, those who hold that present capital recovery allowances are inadequate maintain that this inadequacy is responsible for declines in the ratio of corporate profits to gross national product which have occurred in recent years. They particularly stress the fact that the recent inflation has moved up the prices of capital goods sharply and that present capital recovery allowances which are based on historical costs do not fully allow for the replacement of the real value of the assets concerned. The result, it is claimed, is that capital formation is retarded and economic growth dampened. Another frequently expressed view is that the United States capital recovery allowances are substantially less favorable to business than capital recovery allowances in foreign countries, producing competitive disadvantages for our businessmen vis-a-vis foreign competitors, and a slower rate of economic growth for the United States as compared with foreign countries.

The proposals that are offered to ameliorate this situation take different forms—but all have in common the objective of speeding up capital recovery allowances. Some would broaden the ADR system, perhaps by increasing the range from the present 20 percent to, say, 40 percent. Others would provide a substantial across-the-board reduction in the guideline lives of depreciable assets. Still others propose to divorce depreciation allowances from the useful life concept and would allow depreciable assets to be written off over some relatively brief time period. One such proposal, for example, would permit all machinery and equipment to be written off over 5 years and all industrial buildings to be written off over 10 years, using accelerated methods. A number of proposals also seek to base depreciation allowances on some measure of replacement cost as contrasted to historical cost by adjusting asset costs upward through some price or cost index for purposes of depreciation.

Such liberalization in capital recovery allowances has been opposed on the ground that these allowances are already adequate. Some go beyond their opposition to further liberalization and argue that certain features of the present system are overliberal and should be cut back. For example, it has been suggested that the ADR system should be eliminated and that accelerated depreciation should be modified. Those holding this view frequently stress the large revenue losses that are involved in such features and maintain that it gives business groups unfair advantages compared to other segments of the economy. Moreover, they question whether larger depreciation allowances would have any substantial effect in increasing total investment and economic growth in the United States. Allowing all equipment and structures used in manufacturing, transportation, and public utilities to be depreciated during arbitrary, short periods, using accelerated rates of depreciation would divorce depreciation deductions from any concept of the rate of use to the life of the capital equipment.

Adjustments for inflation

Capital recovery allowances are an important source of saving for the economy. Corporate capital recovery allowances, for example, now account for roughly about two-thirds of total gross business savings (which also includes undistributed profits) and about 45 percent of the total gross private savings of businesses and individuals.

In dollar terms, capital recovery allowances are increasing rapidly. Capital recovery allowances are now running at an annual rate of about $85 million—about twice the 1967 level. However, since such recovery allowances are based on the historical costs of the assets concerned, they do not make any allowance for the effect of inflation. One recent study finds that capital recovery allowances would have had to be increased $15 billion in 1974 in order to adjust for inflation.[1] Moreover, the impact of the current inflation on capital recovery allowances can be seen from the fact that the price increases occurring in 1974 alone accounted for an estimated $7 billion of the total $15 billion of indicated shortfall.

The question of whether adjustments should be permitted for tax purposes in order to take account of inflation is one that applies to many areas besides capital recovery allowances. It has been argued that, while the fact that depreciation charges are not adjusted for inflation tends to result in an overstatement of profits, other factors should be taken into consideration before concluding that such an adjustment should be made. In discussing the subject of adjusting depreciation allowances for inflation, for example, one witness before the committee stated that if such adjustments are made, ". . . they should be combined with parallel adjustments to allow for the gains (in real terms) which result

[1] *Correcting Taxes for Inflation*, William Fellner, Kenneth W. Clarkson and John H. Moore, American Enterprise Institute for Policy Research, Washington, D.C., pp. 27–29.

because the real value of net indebtedness had declined. I understand that some recent work on a sample of balance sheets shows a tendency for the two factors to wash out for large corporations, although the debt factor proves less important for smaller firms with a typically lower leverage ratio."[2]

Another aspect of this issue is whether tax adjustments for inflation should be provided for business as compared with individual taxpayers. One view is that the need to increase productive capacity requires granting such tax adjustments for certain business items, such as capital recovery allowances. Others, however, maintain that it would not be fair to provide tax adjustments for inflation to some groups and not to others. A thoroughgoing system of tax adjustments for inflation for both business and individuals would involve very large losses of revenue.

Effect on investment

A key issue is what effect capital recovery allowances have on investment in plant and equipment as well as on construction. Those who have studied this question in detail have come up with different answers. Some, like Hall and Jorgenson, find that tax policy has been highly effective in changing the level and timing of fixed investment outlays. They also find that tax policy has affected the composition of expenditures. More specifically, they find that accelerated depreciation has resulted in a shift away from equipment toward greater spending for structures while the investment tax credit tends to shift investment away from structures toward equipment. Moreover, Hall and Jorgenson conclude that accelerated depreciation and the investment tax credit have stimulated the level of investment very substantially.[3] However, others like Robert Coen, find the result of accelerated depreciation in stimulating capital expenditures disappointing. Coen finds that the revenue losses involved in granting accelerated depreciation far exceed the additional investments that it induces.[4]

Comparison of cost recovery allowances in the United States with those of foreign countries

Table 9 compares capital cost recovery allowances for industrial machinery and equipment in the United States with those granted in 11 leading industrial nations. It indicates that capital recovery allowances in the United States have been made substantially more generous in recent years, when account is taken of the introduction of ADR in 1971 and the 10-percent investment credit provided under the 1975 Tax Reduction Act. For the first taxable year, for example, aggregate cost recovery allowances constitute about 29.5 percent of the cost of an asset under 1975 law as compared with 21.7 percent under 1962 law. The corresponding cost recovery allowances for the first three taxable years are 60.7 percent under the 1975 law compared with 47.9 percent under the 1962 law; and for the first seven taxable years, 1975 law allows 94.5 percent of asset cost to be recovered as compared with 80.1 percent under 1962 law.

[2] Musgrave, Richard A., Public Hearings before the Committee on Ways and Means, House of Representatives, 94th Cong., 1st Sess., on the subject of tax reform, p. 2519.
[3] *Tax Incentives and Capital Spending*, Gary Fromm, ed., (Studies of Government Finance, The Brookings Institution, 1971.)
[4] *Ibid.*

TABLE 9.—COMPARISON OF COST RECOVERY ALLOWANCES (DEPRECIATION AND INVESTMENT CREDIT) FOR INDUSTRIAL MACHINERY AND EQUIPMENT IN THE UNITED STATES AND 11 LEADING INDUSTRIAL NATIONS

	Representative cost recovery periods (years)	Aggregate cost recovery allowances (percentage of costs of assets) [1]		
		First taxable year	First 3 taxable years	First 7 taxable years
United Kingdom	1	100.0	100.0	100.0
Canada	[2] 2	50.0	100.0	100.0
Netherlands	[3 4 5] 5	14.0	58.0	108.0
Sweden	[26] 5	[7] 60.0	95.7	130.0
Italy	[3] 6	[8] 19.6	[9] 67.9	100.0
Switzerland	[10] 8	12.5	50.8	84.4
	[10 11] 6⅔	15.0	58.4	90.0
France	[12 24] 8	31.3	67.5	[15] 94.9
	[27] 8	25.0	57.8	86.7
W. Germany	[14] 9	[16] 16.7	49.6	[17] 88.8
Belgium	[10] 10	[7 18] 20.0	48.8	[28] 89.0
Luxembourg	[10] 10	[25] 28.0	60.4	94.4
Japan	[6] 11	[19] 34.5	56.9	81.4
	[20] 11	37.1	63.9	88.1
United States:				
1962 Law [13]	[10] 13	[21] 21.7	47.9	80.1
1969 Law [29]	[10] 13	7.7	33.9	66.1
1971 Law [30]	[22] 10½	[21] 23.5	54.7	88.5
1975 Law [30]	[22] 10½	[23] 29.5	60.7	94.5

[1] It is common practice in many countries, prior to investment in fixed assets therein, for investors to agree with the tax authorities as to a rate of depreciation and other benefits available. Such agreements would, in many cases, have the effect of substantially increasing the cost recovery allowances presented in the table above. Th United States does not permit this approach.

[2] Effective May 8, 1972, through December 31, 1974, machinery and equipment acquired for manufacturing and processing of goods in Canada could be written off over 2 years (50 percent per year). A permanent extension of this provision is subject to approval by Parliament.

[3] Straight line method.

[4] Depreciation periods are fixed by agreement. With multiple shift operations, a 5-year life is normal.

[5] Additional 4-percent investment allowance permitted in first and second years.

[6] Modified double declining balance method; 18.9 percent per Japanese Government rate table, salvage value built into rate.

[7] Full year allowance in first taxable year.

[8] Includes additional foreshortened allowance of 15 percent.

[9] Includes additional foreshortened allowances of 15 percent in each of the first three taxable years.

[10] Double declining balance method.

[11] Normal life of 8 years reduced to 6⅔ years to reflect multiple shift operations.

[12] Two-hundred and fifty percent declining balance method.

[13] With investment credit but without ADR.

[14] The average cost recovery period for machinery and equipment in West Germany is 8 to 10 years to which additional allowances are permitted for multiple shift operations: 25 percent of allowance for 2-shift operations and 50 percent of allowance for 3-shift operations. Allowances may be further increased when plant is located in certain areas such as Berlin and areas bordering on Iron Curtain countries. The above table sets forth cost recovery allowances based on an average cost recovery period of 9 years. The double declining balance method is used. A 25-percent additional allowance for 2-shift operations is taken into account beginning with the fifth year when the method is changed to straight line. The corporate depreciation rate thus computed is slightly over the maximum 20-percent rate permitted on a declining method to reflect that: (A) The straight line method produces more depreciation than does the double declining balance method for certain short-lived assets; and (B) Items of machinery and equipment costing less than 800 DM (U.S. $320) can be expensed.

[15] Method changed to straight line in sixth taxable year.

[16] Full year allowances in first taxable year for assets acquired in first half of such year; half year allowance for assets acquired in second half.

[17] Method changed to straight line in fifth taxable year. See 14 above.

[18] Although not considered, installation costs allowed as current deduction which reduces recoverable base cost.

[19] Includes special first year allowance of 25 percent; allowance reduces recoverable base cost in second and succeeding taxable years.

[20] Depreciation in addition to ordinary depreciation in 6 above is allowed to give effect to multiple shift operations. Depreciation multiplied by factor of 1.28 gives effect to 8 hours of daily average excess usage of an item of machinery and equipment.

[21] Includes 14 percent allowance equivalent to 7-percent investment credit at effective 50-percent income tax rate. Credit does not include recoverable base cost.

[22] Thirteen-year recovery period reduced by 20 percent and rounded to nearest one-half year. Double declining balance method.

[23] Includes 20-percent allowance equivalent to 10-percent investment credit (temporary credit enacted in the Tax Reduction Act of 1975) at effective 50-percent income tax rate. Credit does not reduce recoverable base cost.

[24] Although not considered, effect is given to multiple shift operations by reducing service life of assets used under shift conditions.

[25] Includes 18-percent allowance equivalent of 9-percent investment credit at effective 50-percent income tax rate; credit does not reduce recoverable base cost.

[26] Modified declining balance method: 30-percent rate plus additional 30-percent allowance in first taxable year (such additional allowance does not reduce recoverable cost); accumulated cost recovery may not be less than 20 percent of cost for each year asset is in service.

[27] Machinery and equipment purchased between June 30, 1974, and July 1, 1975, limited to 200-percent declining balance method applicable to an asset with an 8-year life.

[28] Method changed to straight line in fifth taxable year. Straight line rate applied to original cost for fifth,

[29] Without either investment credit or ADR.

[30] With both investment credit and ADR.

Note: The capital cost recoveries for each of the foreign countries have been computed on the assumption that the investment qualifies for any special allowances, investment credits, grants, or deductions generally permitted. The deductions in the United States have been determined under the double declining balance method without regard to the limited first year allowances for small businesses.

Source: "The Treatment of Capital Recovery Allowances in the United States and Other Countries," International Tax Journal, vol. 1, May 1975, pp. 265–280.

The table also shows that the United States ranks just below the midpoint of the countries represented in liberality of capital recovery allowances. For example, in capital recovery allowances in the first seven taxable years, the United States ranked seventh among the countries represented, being exceeded in this respect by the United Kingdom, Canada, the Netherlands, Sweden, Italy and France. However, capital recovery allowances in the United States in the first seven taxable years are relatively larger than those in Switzerland, West Germany, Belgium, Luxembourg and Japan.

Revenue considerations

Since capital cost recovery allowances are now running at an annual rate of about $100 billion, it is obvious that any substantial liberalization in these allowances would involve large revenue losses. In the event that it is desired to substantially reduce taxes, an important issue is whether the objective of promoting economic growth would be best achieved through liberalization of capital recovery allowances or through other means such as reduction in corporate income tax rates, liberalization of net operating loss deductions or reductions in individual income tax rates. In this respect, the impact on the budget deficit of any revenue losses that would result from such changes in capital recovery allowances would appear to be an important consideration. To the extent that these revenue losses result in increased budget deficits, they would tend to decrease capital growth since savings would be diminished. Also, to the extent that any revenue losses resulting from liberalization in capital cost recovery allowances are made up through increases in other business taxes or taxes that fall on savings, any encouragement given to capital growth would be offset.

Alternative Proposals

Messrs. Waggonner and Conable

The proposal suggests several alternatives to liberalizing the capital cost recovery system: (1) broaden the ADR system, possibly by increasing the range from 20 percent to 40 percent or, alternatively, by an across-the-board reduction in the guideline lives of depreciable assets, possibly by as high as 50 percent; (2) adopt a price or cost index for depreciation purposes or, alternatively, allow depreciation on the basis of cost plus an arbitrary percentage (for example, 133⅓ percent rather than 100 percent of cost) to take into account estimated increases in replacement costs; and (3) allow the write-off as a current expense of the cost of any equipment if the installation of such equipment is required by State or Federal law or regulation. Mr. Conable would also provide recapture rules relating to the selling of over-depreciated property to limit the conversion of ordinary income into capital gains.

Mr. Jones

The proposal would provide for a rapid cost recovery of certain "nonproductive" industrial equipment: for example, a one or 2-year write-off for equipment such as pollution control facilities, adaption of facilities for handicapped employees, and certain safety equipment. The proposal would require expenditures in this category to be specified.

Messrs. Archer, Crane, and Martin

The proposal would provide a rapid cost recovery system as an alternative to depreciation. Under this system there would be a 5-year recovery period for all productive machinery and equipment and for pollution control facilities. There would be a 10-year recovery period for industrial buildings. The taxpayer could use accelerated methods in calculating the depreciation deductions in a given year. In addition, the proposal would provide for a complete writeoff in one year of required but nonproductive pollution control facilities and equipment.

Mr. Crane

The proposal would provide for the calculation of capital consumption allowances based on actual current replacement costs for plant and machinery.

Mr. Corman

The proposal would not allow depreciation deductions for a taxble year for an amount in excess of the depreciation taken into account in reporting earnings for the year to shareholders. The proposal would also provide that an interest-free loan or a rent-free use of corporation property by a one-percent shareholder would be treated as a cash distribution to the shareholder for tax purposes.

Mr. Stark and Mrs. Keys

The proposal would repeal the Asset Depreciation Range system.

E. Integration of the Corporate and Individual Income Taxes

General

The dual system of corporate and individual income taxes, which taxes corporate income at the corporate level and again at the individual level when it is received as dividends, has been charged by some with being deficient on economic efficiency and equity grounds. On efficiency grounds, it is claimed to impose a double tax on corporate income, and as a consequence to encourage capital which would otherwise flow to the corporate sector to flow to the noncorporate sector, resulting in a misallocation of resources. (This corporate-noncorporate effect has been estimated to involve from .17 to .5 percent of GNP.) [1]

On equity grounds, the present dual system of corporate and individual taxes is claimed to adversely affect recipients of corporate dividends as compared to recipients of other income because the dividend income is doubly taxed.

Also, the current deductibility of interest but not dividend payments is generally thought to bias corporate finance in favor of debt as opposed to equity. Most recently, the burden of debt on corporate balance sheets has been pronounced and integration of the corporate and individual income taxes is offered as a possible source of relief.

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[1] See A. C. Harberger, "The Incidence of the Corporation Income Tax," *The Journal of Political Economy*, LXX, No. 3 and L. G. Rosenberg, "Taxation of Income from Capital by Industry Group," (in Harberger and Bailey, editors), *The Taxation of Income from Capital.* (Brookings, 1969)

This reflects not only the relatively depressed state of equity markets (and the correspondingly poor reception new issues might expect), but also the impact of stringent monetary policies, e.g., high interest rates.

The dual system of taxing of corporate income may be illustrated by the following example: From $100 of corporate gross income, $48 of corporate tax is paid and $52 remains and is available for distribution. If the hypothetical dividend recipient is in the 30 percent bracket, he will pay $15.60 tax on the dividends he receives as well as the initial $48 of corporate tax which the corporation in effect paid for him. His total tax bill then is $63.60. Had he been taxed directly on $100 income, he would have paid $30 in tax. The difference between $63.60 and $30 ($33.60), is then said to represent the excess burden of the corporate tax.

Several assumptions underlie this analysis. First, it is assumed that the corporate tax is paid by the corporation and ultimately by the stockholder and not by consumers through higher prices and/or by labor through lower wages. Second, it is assumed that the corporation and the stockholder are one and the same. That is, it is assumed that corporate managers reflect shareholder interests—that is, there is no "corporate veil." Third, it is assumed that the dividend distribution is complete. In fact, dividend distributions do not always exhaust after-tax earnings. To the extent dividend payout is low, the increase in the firm's equity should be reflected in higher stock prices. This appreciation through capital value is particularly attractive because it allows investors to shelter their corporate income at the long-term capital gains tax rate rather than the rate on ordinary income. In fact, it is widely presumed that high-income individuals do not prefer large dividend payouts and reflect this through their portfolio choice.

With respect to the first assumption, that the stockholders bear the ultimate burden of the tax, there is no widespread agreement on the extent and direction of the shifting of the corporate tax. Some shifting, to consumers and employees no doubt, occurs, and varies among industries. Presumably, the extent to which the tax can be shifted depends on the behavior of consumers the extent to which any company can influence the prices prevailing in its industry and the bargaining power of the company vis-a-vis its employees. There would appear to be a basis for granting tax relief on grounds of double taxation of dividend income to the extent that the burden of the corporation income tax fall on stockholders.

There is another perspective on the corporate and individual taxes which views the corporation and shareholder as related, but separate entities. In this view, the corporation by virtue of its separate standing and perpetuity under law, and the limited liability of it shareholders, derives certain benefits which are the proper base for taxation. Also, some maintain that separate taxes on corporations and individuals favorably diversifies our tax base.

Integration of the corporate and individual income taxes involves eliminating this possible double taxation of corporate income and eliminating the bias toward debt financing. Integration ultimately affects investment because elimination of the "double tax" necessarily reduces taxes paid by corporations or by corporate shareholders, and accordingly raises the rate of return on corporate capital. The increased return to capital in the corporate area in turn induces additional physical investment until the return on the marginal investment equals other opportunities, e.g., the market rate of interest. However, as a counterpart to the increased attractiveness of investment in the corporate area, the flow of capital to the noncorporate areas (e.g. housing and agriculture) would be smaller than under present law.

Integration is complete when one taxes all corporate income at only the individual level. That is, if one presumes corporations are but the sum of shareholders' interests, then retained earnings should be taxed at the individual level.

Alternative Ways of Integrating the Corporate and Individual Income Taxes

There are two basic approaches to integration: complete and partial. Under complete integration, dividends are taxed at the individual level and retained corporate earnings are attributed to corporate shareholders and taxed at the individual level. Thus, under complete integration, there is no separate corporate tax. Under partial integration, a separate tax on corporate income is maintained, and dividends are taxed only once at the individual level. There are a number of mechanisms available to accomplish both complete and partial integration which are conceptually similar but may result in different economic effects as a consequence of the way corporate managers respond to increased pressure for increased dividends. The two complete integration approaches are: the partnership method and the method recommended by the Canadian Royal Commission on Taxation (the Carter Commission) in 1966; the two partial approaches are the dividend deduction and the imputation or "gross-up" method. The July 31, 1975, Treasury proposal before the committee is a combination of these two partial integration approaches.

1. Complete integration

(*1*) *Partnership method.*—Under the partnership method, no tax is levied at the corporate level; all shareholders are viewed as implicit recipients of undistributed profits. Thus, each shareholder would include in his taxable income his share of distributed and undistributed profits. Such treatment currently exists for subchapter S corporations (which have 10 or fewer partners). For large corporations with hundreds of thousands of stockholders, the partnership method has been generally thought to be administratively unworkable, and the presumption that these stockholders exercise an influence over corporate managers is probably unwarranted. (However, the Canadian Royal Commission on Taxation (the Carter Commission) has developed a variant of the partnership approach which seems to meet much of the difficulties just noted.) Additional administrative complications arise over subsequent adjustments to corporate income that might result from audit or litigation. In such circumstances, adherence to the partnership approach would require that individual shareholder tax liabilities be recomputed, which again would prove difficult for large corporations.

(*2*) *Canadian Carter Commission.*—Under the Carter Commission approach, both corporation and shareholder pay taxes; however, a system of credits is devised which amounts to taxation of corporate income only at the individual level. First, dividends would be taxed at the individual level but "grossed up" to reflect the corporate tax already paid. With a corporate rate of 48 percent and $100 of gross profits, the $52 of distributed dividends would be multiplied up by (1/(1–.48)) or 1.923 by the taxpayer and the $100 added into his taxable income. Undistributed profits would be "allocated" to shareholders who would "gross-up" such allocations and include them in their taxable income. The corporate income tax would continue to be collected, but a credit, which would be refundable to taxpayers for whom corporate taxes paid exceeded total individual tax liabilities, would be provided. If a corporation does not distribute all its after-corporate tax profits as dividends, it would notify its shareholders of such "allocations." Shareholders would then "gross-up" these allocations in the same manner as dividends and add the amount to taxable income. For individuals at the top marginal rate of 50 percent (in Canada), no additional tax on dividends would be due since the corporate tax credit would exactly offset the tax at the individual level. For individuals at lower marginal rates of 20 percent, a refund would be due as the credit would exceed the liability at the individual level.

2. Partial integration

(*1*) *Dividend deduction.*—Under this approach, dividends are put on the same basis as interest payments. That is, dividends like interest would be deductible against corporate income. Double taxation of dividends, as previously discussed, would be eliminated, and the corporate tax would become a tax on retained earnings. For corporations which pay out a large fraction of earnings, such an approach would provide substantial tax relief as well as to encourage other firms to pay out more. Some problems might occur to the extent dividends exceed current income; under this approach, it would probably be advisable to provide generous periods to permit carryforward and/or carryback of losses.

(*2*) *Imputation or "gross-up".*—Under this approach, double taxation of dividends is relieved by providing at the individual level a (refundable) credit for taxes paid on dividend income by the corporation as well as grossing up the dividend. In the above example of an individual in the 30-percent bracket who received $52 of dividends, he would have a tax liability of $30 (30 percent times the grossed-up dividends of $100) against which he would use the $48 of corporate tax as a credit. He would receive an $18 refund. Individuals in brackets above 48 percent would experience positive liabilities, although smaller than without partial integration.

3. Special problems

There are a number of difficulties in complete and partial integration of the corporate and individual income taxes which would require special attention.

(*1*) *Low-income individuals.*—For the dividend deduction and imputation or gross-up approaches to be equivalent, the credit at the individual level must be refundable to achieve equity. For many taxpayers, the net impact of the credit will simply be a reduced Federal liability; however, for a portion of them, the credit would need to be refundable.

(*2*) *Tax-exempt organizations.*—Most gross-up or imputation proposals deny this benefit to tax-exempt organizations. Under the dividend deduction approach, unless compensating measures are taken, tax-exempt organizations would substantially benefit. According to a recent study,[2] such organizations owned 18 percent of all listed stock in 1971 and presumably received a substantial portion of aggregate dividends. At issue is whether or not tax-exempt organizations should be treated as individuals for the purposes of integration. If it is decided to adopt integration, the committee may then wish to consider whether or not to further extend this privilege to these groups. Clearly, providing that corporate income earned by tax-exempt organizations is to be free from tax at both the corporate and the shareholder levels would have important equity and revenue implications.

(*3*) *Foreign recipients of U.S. dividends.*—The question arises whether or not the benefits of integration should be extended to foreign stockholders. Under either the dividends-paid deduction or the imputation approach, a foreign shareholder may pay more or less tax on his dividends than his U.S. counterpart. At issue here in particular is the withholding tax on dividends paid to nonresident aliens.

(*4*) *Intercorporate dividends.*—Dividends received from other domestic corporations that had been subject to a withholding tax (or for which a dividends-paid deduction was received) should be exempt from tax in the hands of a stockholding corporation. It might also be considered desirable to exempt intercorporate dividends from any basic corporation tax not treated as a withholding tax. It may be necessary to trace intercorporate dividends back through the different corporate layers to determine the extent of taxation. Currently a deduction is provided for 85% of intercorporate dividends.

(*5*) *Dividends paid from tax-exempt income.*—If imputation or grossup at the individual level is regarded as a corporate tax, a problem would arise to the extent dividends are paid from corporate income that was in fact tax exempt or partly tax exempt. This would include partially or entirely tax exempt interest, excess of percentage depletion over cost depletion, and perhaps capital gains and other kinds of income. The simple grossup method would, unless an adjustment were made, give credit for more than the actual amount withheld on such income. A related problem involves the effective as compared to the nominal corporate rate which is used in the grossup procedure. To the extent the effective corporate rate is below 48%, the grossup and credit will misstate the actual circumstance of the dividends. A similar issue is involved in the question of the extent to which the credit for corporation income taxes should be granted for dividends paid out by

[2] M. E. Blume, J. Crockett, and E. Friend, "Stock Ownership in the United States: Characteristics and Trends," *Survey of Current Business*, November 1974.

corporations with large investment tax credits. In some cases, this could involve granting stockholders tax reduction for dividends on which little or no corporate tax has been paid.

U.S. Experience With Integration of the Corporate and Individual Income Taxes

Nineteenth Century

Under the Civil War income tax, the individual was viewed as the sole object of taxation, and the corporate entity was either ignored or taxed as a source of individual gain. The income tax of 1864 taxed shareholders of mercantile and industrial corporations at graduated rates on their pro rata share of corporate earnings whether distributed or not. Semiprivate businesses, such as railroads and canals, banks, and insurance companies, paid a proportional tax on corporate income. However, the tax was essentially a tax on corporate retained earnings because individuals were allowed to exclude dividend and interest income from their income tax base.

Because the corporate rate was 5 percent, and the individual rate was from 5 to 10 percent, the possibility existed that high-income people would favor dividend income as a source, since it was taxed at a lower rate than ordinary income. In 1865, however, dividend recipients were required to include dividend income in their taxable income, and were allowed to take a credit for the tax (withheld by the corporation) against their individual liability.

Thus, the Civil War income tax combined several approaches to coordination of the corporate and individual income taxes. For entirely private corporations, it pursued what is now called the partnership approach which ignored the corporate entity and taxed only individuals; for semipublic firms, it pursued the gross-up or imputation approach.

1913–1935

Between 1913 and 1916, the normal corporate and individual rates were identical (one percent). Partial integration was achieved by excluding until 1936 dividends from the individual's tax base, although they were included in the calculation of the progressive surcharge. Because the normal rates were identical at the corporate and individual level, the credit allowed for individuals of the tax on their dividend income against their liability amounted to complete integration of the two taxes for those whose incomes were below the level at which the surcharge was imposed ($20,000).

For those persons with income above $20,000, there clearly was an incentive to hold stocks which had low payout ratios, and whose market value accordingly appreciated. Such incentives currently exist, as the maximum individual tax rate on dividends is 70 percent while the long-run rate on realized capital gains is 35 percent. This sort of incentive was recognized in 1913, and shareholders were required to include in their personal incomes their pro rata share of profits on corporations formed for the purpose of avoiding the surcharge rates. Use of personal holding companies and accumulation of earnings beyond the reasonable needs of the business was prima facie evidence of such a purpose.

In the Revenue Act of 1918, personal service corporations (one whose capital was not a material factor in producing income, but whose income was derived from the activities of its principal stockholders) were exempted from the normal and excess profits taxes, and in lieu, its shareholders were taxed directly on their share of profits (whether distributed or not) at individual tax rates. Thus, individuals were taxed only in their capacities as owners and implicit recipients of corporate income.

The Revenue Act of 1921 imposed a penalty tax of 25 percent on income retained for the purpose of tax avoidance. In 1924 the rate was increased to 50 percent. Stockholders had the option, however, if all consented, to declare their share of undistributed profits. Until 1928, the penalty tax was thought to be of no practical significance as it generated essentially no revenue.

In addition to these measures designed to tax undue retained earnings, other measures were enacted to assist in the coordination of the individual and corporate taxes. The basic coordination problem arises from the fact that corporations and individuals pay different rates of taxation. Accordingly, additional undistributed profits were taxed in the Revenue Act of 1917: net income undistributed for more than 6 months was taxed at 10 percent.

In 1927, the staff of the Joint Committee on Internal Revenue Taxation advised against introducing a further tax on undistributed profits, because the disparity between corporate and individual rates had considerably narrowed: the normal corporate rate was 13.5 percent and the maximum individual rate was 20 percent. The Joint Committee suggested a tax credit for dividends paid; however, this provision was not adopted.

The Revenue Act of 1932 widened the gap between corporate and individual rates by increasing the individual income tax surcharge to 55 percent, which was increased in 1934 to 59 percent.

Revenue Act of 1936

In 1936, President Roosevelt proposed a package to coordinate the corporate and individual income taxes by taxing corporate income once. Undistributed profits were to be taxed at the corporate level, and dividends at the individual level.

Final Congressional action provided for a repeal of the exemption of individual income taxes on dividends. Net corporate income was taxed by a surcharge at graduated rates and the capital stock tax was reduced. Finally, the declared-value excess profits tax remained intact.

The surtax on retained earnings was based on income less the normal or proportional corporate tax; a credit against the surcharge was provided for dividends paid. Exemption from the surtax was provided for commercial banks, corporations in bankruptcy and receivership, insurance companies, foreign corporations, corporations deriving a large portion of income from U.S. possessions, those organized under the China Trade Act of 1922, and Joint Stock Land Banks.

Partial integration of the corporate and individual taxes was thus achieved by allowing corporations a credit for dividends paid, and taxing dividends at only the individual level. Remaining (undistributed) corporate income was taxed by the corporate tax at graduated rates. This approach approximates the "split-rate" approach now used in West Germany. In 1938 the undistributed profits tax was rescinded.

As might be expected, the availability of a credit for dividends paid and a progressive tax on retained earnings encouraged a substantial increase in dividends. It has been estimated that during the two years in which partial integration occurred (1936 and 1937), dividend distributions were one-third greater as a result of this changed tax treatment. Substantial inter-industry differences in increased payout occurred. Manufacturing's payout was 40 percent higher, while construction, forestry and fisheries and agriculture paid out 75 percent more. Small and medium corporations had higher payout rates of dividends than did the larger firms as measured by asset size. Apparently, the surtax on retained profits stimulated greater outlays to corporate employees and outlays for maintenance. Larger executive salaries and bonuses enabled owners of small businesses to reduce corporate normal taxes as well as to avoid the surtax.

One of the most serious problems with the 1936 Act was the arbitrary one-year accounting period. Clearly, variations in profits and losses over a longer period of time affect the ability of a corporation to distribute earnings in any 12-month period. This was especially true in the mid 1930's. Similarly, extension of the dividend period beyond the fiscal year was thought by some to be too limited and could subject the individual taxpayer to double tax.

It should be noted that the elimination of the undistributed profits tax in 1939 provided for, in effect, the possible double taxation of dividends. That is, the elimination of the tax and its accompanying credit for dividends paid allowed dividend income to be taxed first at the corporate and then at the individual level.

Revenue Act of 1954

The 1954 Code reduced the tax on dividend income in two related ways. First, an individual was allowed a dividend exclusion of $50; a couple was allowed $100. Second, a credit was provided for imputed corporate taxes paid on those dividends in excess of the exclusion. The (non-refundable) credit was equal to 4 percent of dividends received in excess of $50 (or $100 in the case of a couple, but limited to 4 percent of taxable income.

Dividends paid by life insurance and mutual insurance companies, other than life or marine or fire insurance companies, were not eligible for either the credit or the exclusion. Also, dividends from tax-exempt charitable, educational, or religious corporations were not eligible for the favorable tax treatment.

These two measures did not represent a systematic approach to coordination of the corporate and individual taxes, but rather attempted to provide some tax relief.

Technical Amendments Act of 1958

As a result of the addition of Subchapter S to the Code in 1958, full integration was achieved for certain small business corporations. When tax treatment under Subchapter S is elected, the shareholders include in their own income, for tax purposes, the current taxable income of the corporation, both the portion which is distributed and that which is not. Neither type of income in this case is eligible for a dividend received credit or exclusion.

If a shareholder receives distribution out of previous (prior year) retained earnings which were taxed, no further tax is required. Similarly, operating losses are passed through to shareholders.

The right to elect this treatment was limited to domestic corporations which are not eligible to file a consolidated return with any other corporations and which have 10 or fewer shareholders, whose shareholders are all individuals or an estate, and where the corporation has one class of stock.

For the limited number of cases to which it applies, Subchapter S represents a form of complete integration. In 1971, 262,000 of 1,733,000 corporations (or about 15 percent) were Subchapter S corporations.

Foreign Mechanisms to Achieve Partial Integration

Our trading partners generally provide for some form of partial integration of the corporate and individual taxes; however, none provides for complete integration. The description that follows relates only to domestic corporate dividends which flow to domestic shareholders.

Canada

Partial integration in Canada is achieved at the shareholder level. Corporate taxes are levied at a 48-percent rate. The rate is scheduled to decline to 46 percent in 1976. The individual taxpayer grosses up his dividends by 1/3. A credit is allowed of 20 percent of the grossed-up amount. For a shareholder in the 30-percent marginal rate bracket who receives $100 of cash dividends, his gross-up of dividends would be $133.33, his credit $26.67 (20 percent of $133.33), his gross liability $39.99 (30 percent of $133.33), and his net liability of $13.33. Nonresident shareholders are not eligible for the credit.

West Germany

Partial integration in West Germany is achieved primarily at the corporate level. A two-tier or split-rate tax is imposed on corporate income: there is a 15-percent tax on dividends distributed, and 51 percent on remaining retained earnings. Dividends are taxed at the individual level as ordinary income. Thus, a corporation with $100 gross profits and gross dividends of $40 would pay $6 on the dividends and $30.60 on the $60 of retained earnings.

France

Partial intergration in France, like Canada, is achieved at the shareholder level via the gross-up and credit. Domestic shareholders gross up their dividends by 50 percent and receive a credit against their total tax liability equal to the amount of the gross-up. Thus, a shareholder in the 30-percent bracket with $100 in cash dividends would apply the 30-percent rate against $150, apply a credit of $50, and thus receive a net refund of $5.

Japan

Partial integration is achieved in Japan at *both* the corporate and individual levels. At the corporate level, corporations with capital in excess of $330,000 pay a 30-percent tax on dividends and a 40-percent tax on retained earnings. All dividends paid are subject to a 15-percent withholding tax. Individuals add the 15-percent withheld to arrive at taxable income. The 15-percent withheld and a dividend received credit of 10 percent of the initial amount are then used to offset final liability.

United Kingdom

Partial integration in the United Kingdom is achieved primarily at the individual level. When a dividend is declared, an amount equal to 53 percent of the dividend (the Advance Corporation Tax) is set aside to the Inland Revenue where it is held and credited against the corporate liability. The individual adds the pro rata share of the ACT amount to his net dividend payment for tax purposes and takes a credit in the amount of the ACT against his total liability. The ACT amount is then the gross-up amount. A cash rebate is provided if the credit exceeds total liability.

Distributional Considerations

Stockholdings and dividend payments are highly concentrated in the U.S. In 1972, 18 percent of the taxable returns contained better than 57 percent of all dividend income; 5.4 percent of all taxable returns accounted for 78.5 percent of all dividend income.[3] For this reason, as noted below, about 64 percent of the aggregate tax reduction resulting from tax relief for dividends would go to individuals with AGI in excess of $20,000.

While dividend payments are highly concentrated in upper income brackets, the excess burden of the combined corporate and individual taxes per dollar of dividends is distributed regressively. Under the assumption that corporations pay the corporate tax, the excess burden of the double tax may be defined as the difference between current taxation and amounts due if corporate income were taxed only at the shareholder level. Under the assumption that complete a payout of after-corporate tax earnings in the form of dividends occurs, the excess burden is equal to gross profits times the difference between the corporate tax rate and the corporate rate times the individual rate.[4]

Under no payout, the excess burden is simply gross profits times the difference between the corporate rate and the individual rate.[5]

Table 10 provides illustrative calculations of the excess burden under dividend payout and no payout assumptions. Under the payout assumption, the excess burden of current taxation of $100 of corporate income is $48 for the individual with no Federal individual liability and $14.40 for the individual in the 70-percent bracket. Under the no-payout assumption, the excess burden is again $48 for the zero-tax rate person and falls to zero for the 48-percent individual. Thereafter, as individuals in tax brackets above 48 percent, the excess burden of current tax law is negative. That is, they would experience a tax increase under integration.

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[3] *Statistics of Income 1972*, Individual Income Tax Returns, table 1.4.

[4] Let P be gross profits, c. the corporate tax rate, and i the individual tax rate. Current law is the sum of corporate tax cP, and the individual tax on dividends, i(1–c)P. Pure integration is iP; the excess burden is then cP+i(1–c)P less iP, or P(c–ci).

[5] That is, Pc would be current law and Pi pure integration. The difference or excess burden is P(c–i).

TABLE 10.—EXCESS BURDEN OF CORPORATE TAX UNDER ALTERNATIVE PAYOUT ASSUMPTIONS, $100 GROSS PROFITS

Marginal tax rate in percent	Complete payout of earnings — Total tax burden — Current law [1]	Complete payout of earnings — Total tax burden — Pure integration	Complete payout of earnings — Excess burden	No payout of earnings [2] — Total tax burden — Current law	No payout of earnings [2] — Total tax burden — Pure integration	No payout of earnings [2] — Excess burden
0	$48.00	0	$48.00	$48	0	$42
14	55.28	$14.00	41.28	48	$14	34
15	55.80	15.00	40.80	48	15	33
16	56.32	16.00	40.32	48	16	38
17	56.84	17.00	39.84	48	17	31
19	57.88	19.00	38.88	48	19	29
22	59.44	22.00	37.44	48	22	26
25	61.00	25.00	36.00	48	25	23
28	62.56	28.00	34.56	48	28	20
32	64.44	32.00	32.64	48	32	16
36	66.72	36.00	30.72	48	36	12
39	68.28	39.00	29.28	48	39	9
42	69.84	42.00	27.84	48	42	6
45	71.40	45.00	26.40	48	45	3
48	72.96	48.00	24.96	48	48	0
50	74.00	50.00	24.00	48	50	−2
53	75.56	53.00	22.56	48	53	−5
55	76.60	55.00	21.60	48	55	−7
58	78.16	58.00	20.16	48	58	−10
60	79.20	60.00	19.20	48	60	−12
62	80.24	62.00	18.24	48	62	−14
64	81.28	64.00	17.28	48	64	−16
66	82.32	66.00	16.32	48	66	−18
68	83.36	68.00	15.36	48	68	−20
69	83.88	69.00	14.88	48	69	−21
70	84.40	70.00	14.40	48	70	−22

[1] Ignores hundred dollar dividend exclusion.
[2] Capital gains effects of retained earnings not considered.

The negative excess burden under the no-payout assumption coupled with the current 50 percent maximum tax rate on individual earnings, 70 percent maximum rate on dividends and 48 percent corporate rate highlight the relationship between capital gains taxation and taxation of corporate income. The individual with large equity holdings will minimize his tax liability over time if he holds low payout stock which in turn appreciates more rapidly. To the extent the tax rate on realized capital gains is less than the tax rate on other sources of income, the taxpayer who can afford to wait to realize his income will benefit from both the lower tax rate and deferral of taxes. The operating integration schemes in other countries attempt to address these matters. Canada, for example, has a top individual marginal tax rate that equals the corporate rate, and taxes one half of capital gains when realized as ordinary income. In this way, greater neutrality is achieved with regard to the timing of tax realization and choice of source of income.

Finally, there are likely to be windfall gains for stockholders if integration of the corporate income tax and the individual income tax is adopted. This is because, to the extent that the burden of the corporation income tax now falls on the stockholder, this burden is taken into consideration in stock prices. Complete or partial removal of the burden would therefore tend to increase stock prices.

Economic Effects of Integration

Prediction of the long-run effects of integration on aggregate investment/saving and economic growth depends on the initial shifting assumption one makes and the subsequent payout and savings responses of corporate managers and shareholders respectively. Under the dividend-deduction approach, it seems reasonable to expect there would be a substantial incentive for increased dividends, as such deduction at the corporate level would have immediate and visible effects on corporate tax liability. A firm under the dividend-deduction approach will be able to pay out 52 percent of gross profits and achieve an after-corporate tax earnings position that is identical to its current situation *before* dividend distribution. This incentive is more blunted under the imputation or "grossup" approach for it is shareholder pressure that would motivate the dividend payout. This general pressure might be smaller yet from high-income taxpayers, for as displayed in Table 2, they would experience higher taxes.

The importance of dividend payout responses to integration raises questions as to whether the additional dividends will be consumed or saved by individuals and what the retained earnings situation of private corporation will be. Since undistributed profits constitute savings, any reduction in such profits as a result of increased dividend payouts will reduce savings unless stockholders save all the increased dividends although it may also encourage individuals in the aggregate to buy more stock.

Finally, because without other tax increases integration involves substantial revenue losses, the impact of integration on the public sector's budgetary balance needs to be considered as well. Thus, each of the three sources of saving may increase, decrease or stay the same in response to integration, and aggregate investment may increase, decrease or remain as before.

Integration that is not offset by tax increases in other areas will increase the return to corporate capital, induce additional investment demand, and shift resources from the noncorporate to corporate sector. To the extent an additional dividend payout occurs, it seems likely that additional efficiency gains will be realized in the capital market as dividend recipients decide where to reinvest those dividends. Also, corporations would seem to treat debt and equity financing on a more equivalent basis, and some efficiency gains should be realized there as well. However, whether or not the aggregate investment rate will permanently increase depends on aggregate savings behavior. Any effect that integration may have in increasing savings may be offset to the extent that integration is financed by tax increases in other areas. If, for example, the revenue losses due to integration were recouped from higher taxes on business, the increase in investment incentives resulting from integration could be offset completely.

The ability of integration to permanently increase the aggregate investment rate depends then on the responsiveness of aggregate savings to the higher return capital. Empirical evidence on this is limited and inconclusive. To some extent, the unresponsiveness of household sector saving to interest rates reflects the peculiarities of our financial structure, Regulation Q limitations on interest rates, and the relative absence of attractive debt instruments for moderate-income families.

The case for integration rests on the extent to which it will increase the aggregate savings rate (which is uncertain), the gains in efficiency that will result from a more efficient operation of the capital market, some aggregate efficiency effects of relieving the excess tax on capital, and some gains in equity that may result from eliminating the double taxation of corporate income. Again, to the extent the corporate tax is shifted to consumers and employees, however, the importance of double taxation as a source of inequity to stockholders is reduced.

Alternative Proposals

Administration

The Administration has proposed a plan to partially integrate the corporate and individual income taxes through is a combination of the dividend deduction and imputation or gross-up approach. Under this proposal, elimination of the double taxation of dividends would occur at both the corporate and stockholder levels.

At the corporate level, a dividend deduction would be provided as of 1977, and phased in through 1982. By 1982, approximately half of dividends would be deductible. At the individual level, imputation or grossup would begin one year later in 1978, and be phased in through 1982. With both a dividend deduction of 50 percent and a gross-up of dividends of 50 percent permitted in after completion of the phase-in, somewhat more than the double tax would be eliminated. This would occur because of the relationship of the corporate tax rate to the gross-up factor. With 50 percent corporate tax rate the gross-up factor in the split proposal would be exactly 50 percent and the double tax would be reduced to just a single tax on dividend income. However, because the corporate rate is less than 50 percent, the gross-up factor which would permit an exact reduction of the double tax is an odd fraction (48.0769 percent) which may cause taxpayers difficulty. By using a 50 percent gross-up factor, some simplification would be achieved at the individual level; however, this causes some uncertainty about the fraction of dividends that would be deductible during and at the end of the phase-in.

The initial revenue loss of the proposal in 1977 is estimated to be $2.5 billion. The administration intends to restrict the proportion of dividends which may be initially deducted to that which yields a $2.5 billion revenue loss. In 1978, when gross-up begins at the individual level, it is estimated that the additional revenue loss will be $1.25 billion, although this is based on 1977 dividend levels. Of course, these costs involve only first-year effects; in subsequent years substantially larger amounts would be involved.

Messrs. Waggonner and Conable

The proposal would consider starting partial integration of the corporate and individual income taxes in 1976 and phase it in over a 4–5 year period. It was indicated that the committee should consider separate partial integration plans, e.g., either a dividend deduction approach at the corporate level or a credit to stockholders for dividends received, or some elimination of the corporate income tax and an allocation of retained earnings to the shareholder. Mr. Conable would include certain credits to encourage small investments in stock as part of any integration scheme.

Mr. Vander Veen

If the committee should consider capital formation in the first phase of tax reform, it was suggested that consideration of the Administration's integration approach be on a limited basis. For example, the committee could decide to make dividends from new equity issues tax-exempt until 3 years after enactment of the bill.

Evaluation

Each of the partial integration proposals seeks to limit its immediate revenue impact by phasing in the elimination of the double-tax on dividends over a 4- to 6-year period. Many of the special problems associated with particular forms of integration need further attention in the proposals. The Administration noted this in their July 31, 1975 presentation by Secretary Simon and indicated, should the committee pursue a particular form of integration, an interest in working out the problems of intercorporate dividends, tax-exempt organization, etc.

Revenue Effects

The staff estimates that a partial integration plan achieved at the stockholder level by the imputation or gross-up of dividends by 48 percent and the provision of a refundable credit, if implemented in 1975, would cost $12.1 billion in revenue. Under this plan, the current dividend exclusion would be removed and the credit would not be available to tax-exempt or foreign recipients of U.S. dividends. While the imputation approach at the shareholder level is in some respects more complicated than a dividend deduction at the corporate level, this disadvantage is balanced by the relative ease with which the problems of tax-exempt organizations (which own 18 percent of listed stock) and foreign recipients of U.S. dividends are solved. In some respects, the Administration's proposal exacerbates the administrative problems of implementing a partial integration plan by foregoing the simplicity of the dividend deduction plan by including partial withholding, and by foregoing the problems posed by the tax-exempt and foreign receipt of dividends by including a partial dividend deduction approach with the imputation or gross-up approach.

The estimated impact by AGI class of the gross-up approach is provided in Table 11.

TABLE 11.—IMPACT OF PARTIAL INTEGRATION OF CORPORATE AND INDIVIDUAL INCOME TAXES: GROSS-UP APPROACH

Original AGI class (in thousands of dollars)	Present tax (in millions of dollars)	Tax reduction: Amount (in millions of dollars)	Tax reduction: Percent change	Tax reduction: Percent of total
To 0	17.90	162.87	909.9	1.3
0 to $5	348.56	521.91	149.7	4.3
$5 to $10	7,532.80	1,132.72	15.0	9.3
$10 to $15	14,378.64	1,161.42	8.1	9.6
$15 to $20	15,403.11	1,416.56	9.2	11.7
$20 to $30	18,470.25	2,398.87	13.0	19.8
$30 to $50	11,989.59	2,034.51	17.0	16.8
$50 to $100	8,787.80	1,473.52	16.8	12.2
$100+	8,258.32	1,820.82	22.0	15.0
Total	85,186.98	12,122.21	14.23	100.0

Note: Dividends at 1975 levels. Figures relate to individuals; tax exempt and foreign recipients of U.S. dividends are not extended the benefit of integration. No change in corporate payout is assumed; the tax credit is fully refundable, and a gross-up factor of 1.923 is assumed and dividend exclusion is repealed.

The largest tax reductions occur in the lowest and top brackets. Overall, this partial integration plan would reduce individual taxes by 14 percent at 1975 levels. Because stock holdings are concentrated in the higher brackets, 44 percent of all tax reductions would go to those in the $30,000 and above AGI classes and 64 percent to those in the $20,000 and above AGI classes.

F. Corporate Surtax Exemption and Tax Rates

Present Law

Corporate income is generally subject to a normal tax of 22 percent and a surtax of 26 percent, with the initial $25,000 of taxable income exempt from the surtax. In the Tax Reduction Act of 1975 the surtax exemption was increased to $50,000 and the normal tax was reduced to 20 percent on the initial $25,000 of taxable income. Both changes applied only to the year 1975.

Issues

The increase in the surtax exemption in the Tax Reduction Act of 1975 was included in both the House and Senate bills. The Senate bill included a provision that reduced the normal tax rate from 22 percent to 18 percent and increased the surtax rate from 26 percent to 30 percent. This would have involved a revenue loss of $700 million. The 2-point reduction in the normal tax rate on the initial $25,000 of taxable income was adopted in conference.

These tax reductions are generally viewed as attempts to provide tax relief to small businesses. The increase in the surtax exemption from $25,000 to $50,000 provides a tax reduction of $6,500 (.26 × $25,000) to all corporations with taxable income above $50,000, a smaller reduction to corporations with taxable income between $25,000 and $50,000, and no tax reduction for corporations with taxable income below $25,000. Thus 24 percent of this reduction is received by corporations with taxable income below $50,000.

The Senate adopted the provision that "moved" four percentage points from the normal tax to the surtax in response to concern that increasing the surtax exemption did relatively little to help corporations with taxable income below $25,000.

Under the compromise adopted in conference, there is a 2-point reduction in the normal tax on the first $25,000 of taxable income. Fifty-seven percent of the tax reduction goes to corporations with incomes less than $50,000.

Temporary reductions in corporate tax rates for small corporations are not viewed as effective in stimulating business investment as increases in the investment tax credit. When a corporation is considering whether to make an investment, it is concerned with what the tax burden will be on the income produced by the investment, income that is usually received over a long period of time. A one-year reduction in corporate tax rates, therefore, has only a small effect on expected after-tax rates of return, so it provides little stimulus to new investment. A permanent reduction in corporate tax rates, however, would increase after-tax returns over the life of a new investment and, therefore, may be as effective at stimulating investment as an increase in the investment credit.

A reduction in corporate tax rates increases the incentive to invest only insofar as it reduces the marginal tax rate; that is, the rate applied to additional income. For example, a corporation with taxable income of $100,000 receives a $6,500 tax reduction as a result of the increase in the surtax exemption from $25,000 to $50,000. Each additional dollar of taxable income that the corporation would receive from a new investment, however, would still be taxed at a 48-percent rate, and it is this tax rate that the corporation will use in calculating the expected profitability of a new investment.

Increasing the surtax exemption from $25,000 to $50,000 reduces the marginal tax rate for a corporation whose income is between $25,000 and $50,000. A corporation with income below $25,000 receives no tax reduction at all, while a corporation with income above $50,000 receives a $6,500 tax reduction but experiences no change in the tax rate applicable to additional income. Since only 3.7 percent of corporate income is received by corporations with taxable income between $25,000 and $50,000, the increase in the surtax exemption is not likely to induce substantial additional investment.

The 2-point reduction in the normal tax rate on the first $25,000 of income reduces the marginal tax rate for corporations with taxable income below $25,000, which receive 5.4 percent of corporate income, but not for firms with higher income. This propsal is an efficient investment stimulus since most firms experience a reduction in their marginal tax rate.

Alternative Proposals

Tax Reduction Act of 1975

The 1975 Act provides for an increase in the corporate surtax exemption from $25,000 to $50,000 and reduces the corporate normal tax rate from 22 percent to 20 percent on the first $25,000 of taxable income. These reductions apply for one year—for taxable years ending in 1975.

Mr. Ullman

His proposal would continue for four more years (through 1979) the corporate tax reductions contained in the Tax Reduction Act of 1975.

Messrs. Waggonner, Conable, and Archer

The proposal would reduce the 48-percent tax rate on corporations, possibly to 42 percent, and increase the corporate surtax exemption, possibly to a permanent level of $100,000. The proposal would accomplish the rate reductions by reducing either the corporate normal tax rate or the surtax rate or some combination of both.

Messrs. Pickle and Ketchum

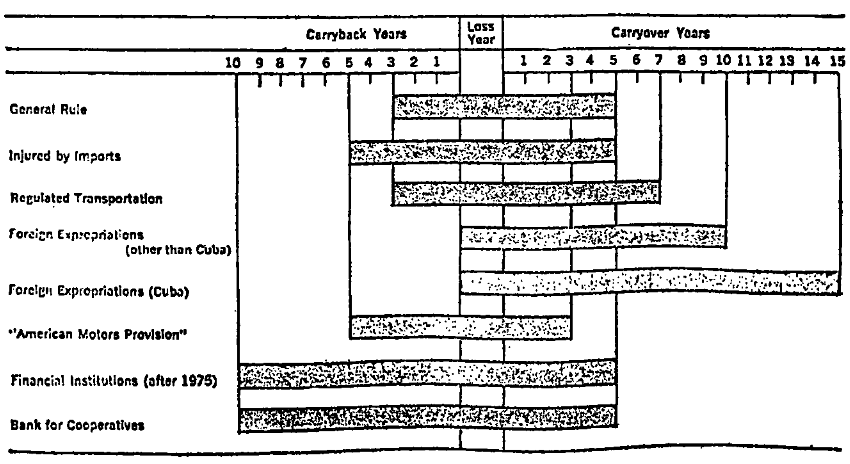
The proposal would increase the corporate surtax exemption permanently to $100,000.

G. Net Operating Loss Carrybacks and Carryovers

Present law

Present law, in general, provides that a taxpayer is allowed to carry a net operating loss back as a deduction against income for the 3 years preceding the year in which the loss occurred and to carry any remaining unusued losses over to the 5 years following the loss year. This general rule enables taxpayers to balance out income and loss years over a moving 9-year cycle, to the extent of taxable income in the 3 years preceding, and the 5 years following, any loss year. A net operating loss carryback results in a refund of income taxes to the extent that the carryback offsets taxable income previously reported for the carryback years.

CHART 1.—NET OPERATING LOSS CARRYBACK AND CARRYOVER PERIODS FOR DIFFERENT CATEGORIES OF TAXPAYERS



Present law also provides several exceptions to the general 3 year carryback-5 year carryover rule in the case of certain industries or categories of taxpayers, as indicated in chart 1. One exception allows certain regulated transportation corporations to carry back and deduct net operating losses for the usual 3 years and to carry over such losses for 7 years. Another exception prohibits the carryback of a net operating loss to the extent the net operating loss was attributable to a foreign expropriation loss. However, a 10-year carryover period is allowed for the foreign expropriation loss (15 years in the case of a Cuban expropriation loss).

A third exception, applicable to financial institutions for taxable years beginning after December 31, 1975, lengthens the carryback period for net operating losses to 10 years and allow the usual 5-year carryover period. Similarly, a bank for cooperatives is presently allowed to carry net operating losses back for 10 years and forward for 5 years. A fourth exception is provided for taxpayers which have incurred net operating losses resulting from increased imports of competing products under trade concessions made pursuant to the Trade Expansion Act of 1962. Where a taxpayer has elected to obtain certification as provided by this Act, it is allowed a 5-year carryback period and the usual 5-year carryover period.

Present law also contains a provision designed for American Motors Corporation permitting a 5-year carryback period and a carryover period of 3 years for losses incurred for taxable years ending after December 31, 1966, and prior to January 1, 1969.

Insurance companies are allowed, either under the general rule discussed above or under other special provisions, to average operating losses over a 3-year carryback period and a 5-year carryover period.

Senate action in the Tax Reduction Act of 1975.—The Senate Finance Committee included in the Tax Reduction Act of 1975 (H.R. 2166) a provision which generally would have allowed business taxpayers, both individuals and corporations, to elect to convert carryover periods to which they are entitled under present law into carryback periods. For example, a taxpayer now subject to the general rule could have elected to use an 8-year carryback period (3-year carryback under present law and an additional 5-year carryback under the new provision) with no carryover period.[1] This election was applicable to net operating losses for taxable years ending after January 1, 1970.

The Senate Finance Committee provision was revised on the floor of the Senate. As passed by the Senate, the intent of the provision was to allow taxpayers generally an election to convert carryover periods for which they are presently eligible into additional carryback years for net operating losses incurred for taxable years 1974 and 1975.

In addition, the Senate amendment provided that where a corporation would receive a tax benefit, under an elective carryback, of more than $10 million, 25 percent of such tax benefit from the first year of the extended loss carryback was to be placed in an employee stock ownership plan ("ESOP") over a 10-year period. A corporation could also put up to 50 percent of this amount (of the 25 percent) into a supplemental unemployment benefit plan if transferred within one year from the time of election.

This Senate provision was deleted in the conference on the Tax Reduction Act of 1975.

Problem

Net operating loss carrybacks and carryovers provide business taxpayers with a form of averaging which, in effect, permits them to share their losses with the government by offsetting these losses against their taxable income in other years (within the prescribed time limitations. This is generally regarded as equitable since taxpayers are required to share their income with the government by paying income tax when they have profitable years.

However, there have been proposals to revise the present carryback—carryover rules by permitting longer carrybacks or carryover periods and by allowing taxpayers an option to substitute carrybacks for carryovers. Others would provide a longer carry forward period. These proposals stem, in large part, from the fact that in the current economic situation—and in particular in certain depressed industries—taxpayers have incurred substantial losses which they cannot offset fully against the income of other years. Such taxpayers, for example, may not be able to offset fully their losses in the present carryback period because these losses are large and the prior years were either loss years or low income years. Moreover, a number of these companies

[1] The carryback election under the Senate Finance Committee bill would not have been available, however, to certain taxpayers allowed extended carryovers or carrybacks under present law—those having foreign expropriation losses, certain financial institutions, and Banks for Cooperatives.

doubt that they will be able to fully offset such losses through carryovers because they anticipate only modest profits in the future years covered by the present carryover.

Liberalization of the net operating loss provisions is also supported as an effective way to assist temporarily nonprofitable businesses which derive no immediate benefit from the usual capital formation and recovery provisions such as increased investment tax credits, accelerated depreciation deductions, rate reductions or dividend deductions.

Proposals to liberalize the net operating loss provision involve a number of issues. These proposals generally involve substantial loss of revenue, especially if, as is frequently the case, they are made retroactive to losses incurred in past years. Elective loss carrybacks also involve considerable administrative complexities, with resulting difficulties of enforcement.

In addition, as outlined below, if the committee desires to liberalize the net operating loss provision, there are important choices to be made as to how the changes should be structured.

Electing to substitute carrybacks for carryforwards.—One important issue concerns what changes should be made in the present carryback and carryover rules. In general, while they are aimed at the same objective of granting tax relief to businesses which suffer net operating losses, carrybacks and carryforwards have somewhat different effects on the taxpayer and on the government.

So far as the taxpayer is concerned, whether a longer carryback or a longer carryforward is desired depends on the business's pattern of income and losses over the years. Taxpayers which have had a very long string of annual losses which extend beyond any feasible carryback period will ordinarily prefer carryforwards because the business will not be in a position to benefit from longer carrybacks. Similarly, new businesses which, of course, have no income in past years against which to apply carrybacks will generally prefer longer loss carryforwards. However, taxpayers with sufficient income in past years to benefit from carrybacks are apt to prefer carrybacks to carryforwards, particularly since carrybacks provide tax refunds, while obtaining the benefit of carryovers is dependent upon the ability of the business to earn profits in future years. A rule requiring business losses to be carried forward also provides an incentive to the business to operate efficiently so as to generate future income which can absorb the earlier loss.

In order to give taxpayers greater flexibility to adapt net operating loss deductions to their particular circumstances, it has been proposed that taxpayers should be given the option of substituting additional carryback years (on top of the existing carryback years) for their presently allowable carryover years. This would give the company the option of taking loss offsets within a prescribed number of years as carrybacks or as carryforwards. Under this approach, for example, instead of the general 3-year carryback—5-year carryforward, a taxpayer might elect to carry back his losses for 8 years with no carryforward, or to carry his losses forward for 8 years with no carryback. If this approach were adopted, longer carrybacks would be frequently elected by taxpayers desiring to secure relatively speedy refunds to bolster their business positions.

Proposals of this type require some means of preventing undue tax advantages from being secured by switching from one option to another. Such undue tax advantages might be secured, for example, if a taxpayer who elected and fully utilized an 8-year carryback (in lieu of the 5-year carryforward) were permitted to switch back without any adjustments to the regular 3-year carryback—5-year carryover when carrybacks are no longer helpful to him and when there are good prospects for profits in future years. A taxpayer who wants to elect an extended loss carryback as a "one shot" matter, and then to revert to the regular 3-year/5-year averaging pattern for a business loss suffered in a later year, may have received an excessive advantage from the elective carryback in several ways. First, he may have received a refund from the extra carryback years available under the election where he could not have fully used the same loss as a carryover under the regular 3-year/5-year pattern. Second, an operating loss which is carried back rather than forward may, in effect "free" taxable income earned in a later year to be absorbed by another loss year (where the latter loss could not have been fully used if the taxpayer had not elected to carry back his earlier loss).

If an elective loss carryback approach is adopted, consideration might be given to requiring a taxpayer who has made the election (to substitute carrybacks for carryforwards) to refund the extra tax savings that have resulted from the election if he switches back to the regular 3-year carryback—5-year carryover period.

One complexity involved in a recapture rule of this kind concerns when the existence of an advantage from the election is to be determined, namely, at the time that the taxpayer revokes his election and reverts to the basic 3-year/5-year pattern, or in the future year when it can be determined whether the additional loss carryback could have been fully "used" as a 5-year carryover.

Moreover, since such a taxpayer would have enjoyed interest-free use of the amounts of tax reduction resulting from the exercise of the election, consideration might also be given to adding interest to the amount of any repayment that the taxpayer is required to make when he switches back to the regular 3-year carryback—5-year carryover.

Time period covered by carrybacks and carryovers.—The time period over which loss carrybacks and/or carryovers are to be permitted is another important issue. Proposals, for example, have been made to extend the present 8-year period for carrybacks and carryforwards to a 10-year period. It has also been proposed to allow an election to carry over net operating losses 10 years in lieu of the present 3-year carryback—5-year carryforward. In theory, there seems little objection to a longer period as such, except that the longer the period over which the losses can be offset, the greater the loss in revenue to the government. As a practical matter, however, the longer the carryover period, the greater the likelihood of trafficking in loss corporations.

It is sometimes maintained that longer carrybacks do not result in substantial revenue losses because a taxpayer who utilizes them will have smaller (or no) carryovers in future years. However, a rule which allows taxpayers to carry back losses beyond the present carryback period (3 years) is likely to involve significant loss of revenue because there is no assurance that particular taxpayers will, in fact, have sufficient profits in future years against which to offset such losses. Similarly, longer carryover can also involve revenue losses.

In general, the longer the period over which a loss carryback can be used, the greater are the administrative problems. A long carryback period, for example, requires the recomputation of tax for past years, and the further such past years go back, the greater the problem of recomputing the tax from a taxpayer's old books and records. The present 3-year carryback period appears to have been designed, in part, to correspond with the 3-year period for the statute of limitations for applying tax assessments.

Economic effects—Both carrybacks and carryovers encourage business investment because they offer taxpayers some degree of assurance that they will receive tax relief if they incur losses. This appears especially important to risky businesses and to businesses subject to marked cyclical variations characterized by substantial profits in some years and substantial losses in others. In a sense, loss carryforwards, as their name implies, are more "forward looking" than a carryback insofar as incentives are concerned, since in order to benefit from any current loss, the taxpayer must continue in business and earn profits in future years. As noted above, carryforwards are generally more helpful to new businesses than are carrybacks.

Carrybacks tend to be more helpful to the older established businesses; they appear to have a greater countercyclical stabilizing effect on the economy than carryforwards. While business losses can occur in any phase of the business cycle, they are more apt to occur in periods of recession. Accordingly, when a loss is incurred and the taxpayer takes a carryback against the income of a past year, the result is receipt of a prompt refund which can help the taxpayer when he generally needs such financial help and when the economy needs the infusion of funds.

In contrast, since loss carryovers are applied against profits and large profits tend to occur when the economy is booming, carryovers have a tendency to reduce taxes in boom periods when the taxpayer may not be in great need for funds and when tax reduction may not be appropriate because of an inflationary situation.

Retroactive effective date.—Another issue involved in proposals to liberalize the net operating loss concerns the effective date of the change. In general, a case could be made for limiting any elective carryback to losses sustained in current and future tax years.

However, such a rule would not give a number of companies the relief that they are seeking with respect to large losses in past years. One auto manufacturer, for example, is seeking relief for large losses incurred in 1974 as well as in 1975; an aircraft manufacturer is seeking relief for large losses incurred in 1973; and an air carrier is seeking relief for large losses incurred in 1970 and 1971. A retroactive effective date could extend relief to such taxpayers for their losses in past years, but would increase significantly the revenue loss involved in liberalizing the net operating loss deduction.

Sales of loss carryovers.—At present, there is substantial "trafficking" in the sale of loss carryovers, primarily for tax purposes. Profitable business enterprises, for example, may now acquire businesses with loss carryovers mainly to make use of these loss carryovers against the profits of their businesses.

Under the present law, where the loss corporation is the acquired corporation in a taxfree reorganization or in a sale of stock to new owners, there are certain limitations on the availability of the acquired corporation's loss carryforwards to the acquiring corporation. The principal limitations are:

(1) If more than 50 percent of the stock is purchased within 2 years and by the end of that period the business of the acquired corporation has changed, then the loss carryforwards are eliminated (sec. 382(a)).

(2) If all the assets of the corporation are acquired in a tax-free merger, then if the shareholders of the acquired corporation obtain less than a 20-percent interest in the acquiring corporation, the loss carryforwards are reduced by 5 percentage points for each percentage point less than 20 that the acquired company's shareholders own in the acquiring company. (For example, if the acquired company's shareholders obtain a 12-percent interest, only 60 percent of the loss carryovers are allowed.) (Sec. 382(b).)

(3) If a corporation is acquired with a principal purpose to evade or avoid income tax, then the loss carryovers may be disallowed in whole or in part (sec. 269).

(4) If one corporation acquires more than 80 percent of the stock of another (either in a taxable or a tax-free acquisition) and then files a consolidated return, the preacquisition losses of the corporation acquired can be used only against the income of that corporation.

However, while these limitations restrict, they by no means eliminate the advantages of "trafficking" in loss carryforwards from an acquired corporation.

Available data suggest that such trafficking in loss carryovers is extensive. In 1974 there were 224 advertisements in the Wall Street Journal relating to the sale or purchase of loss carryover corporations. A total of $250 million of loss carryovers were involved in those advertisements in this group that cited dollar figures, and inclusion of the cases in which dollar figures were not cited undoubtedly would have boosted this figure to a much higher level. Moreover, the $250 million figure does not reflect the substantial volume of transactions in loss carryovers which are consummated without being advertised.[2]

Limiting more liberal loss carryovers to economic losses.—Another issue is whether any option that is granted to taxpayers to take liberalized net operating losses should be limited to true economic losses as contrasted with "tax" losses. The present net operating loss provisions already contain some limitation of this type, in that the Western Hemisphere Trade Corporation deduction is not allowed to corporations for purposes of computing net operating losses as well as the income against which such carrybacks or carryforwards are applied. Also, for such purposes, individual taxpayers may not deduct one-half of their long-term capital gains.

[2] See testimony of Michael Waris, Jr., in Public Hearings before the Committee on Ways and Means, House of Representatives, 94th Congress, 1st Session, on the Subject of Tax Reform, Part 5 (July 29–31, 1975), page 3589.

Moreover, before 1954, an economic loss concept was employed for purposes of computing net operating losses, in that the taxpayer was also required to include tax-exempt interest, the excess of percentage depletion over cost depletion, and the full amount of intercorporate dividends in computing the income of both the current loss year and the year to which the loss was carried. However, under present law, these adjustments are not required.

If the committee decides to adopt an "economic loss" concept in connection with a decision to liberalize the net operating loss rules, consideration might be given to requiring those who elect to take an elective longer carryback to add back the following items for purposes of computing income in both the loss year and in the year to which the loss is carried back or carried over:

—Tax exempt interest;
—The excess of percentage depletion over cost depletion, and
—100 percent of intercorporate dividends (instead of only 15 percent of intercorporate dividends as a result of the present 85 percent dividends received deduction).

Other items of tax preference could be treated in a manner similar to the capital gains preference of individuals.

These tax adjustments would involve some additional complications in the tax returns but the complications do not appear to be major.

Requiring the establishment of an ESOP by firms securing large tax benefits from liberalized net operation loss deductions.—A number of proposals would require firms receiving substantial tax relief as as result of exercising an election to take a longer loss carryback to share the resulting tax savings with their employees through establishing an employee stock ownership plan (ESOP). As noted earlier, the Senate version of the Tax Reduction Act of 1975 contained a provision to liberalize the net operating loss deduction (subsequently deleted in conference), which included a requirement for the establishment of an ESOP by firms enjoying over $10 million of tax savings under the election.

The Tax Reduction Act of 1975, as enacted into law, permits a taxpayer to claim an 11-percent investment credit for the period begining January 22, 1975, and ending December 31, 1976, instead of a 10-percent credit, if it establishes an ESOP and contributes the extra tax benefit to the ESOP. The objective of the ESOP is to increase employee ownership in firms to give them a greater stake in the business, to encourage them to put forth their best efforts and to permit them to share in the profits. An ESOP also offers unique financing advantages to a corporation—in some cases, enabling it to borrow money from a bank and then effectively to deduct the funds it uses to repay the principal of the loan.

However, some have questioned whether it would be desirable to grant special tax inducements for the establishment of ESOP's beyond those already provided by present law, on the ground that heavy stock ownership by employees is not always desirable for the employees, particularly where the enterprise is very risky. An additional consideration concerns the desirability of requiring businesses which have incurred large losses to establish ESOP's as a condition for securing tax relief that is designed to help put them on their feet.

Alternative Proposals

If the committee believes that it would be desirable to liberalize the present rules relating to carrybacks of net operating losses, but also believes that an elective carryback involves technical and administrative complexities, it might simply equalize the carryback and carryover periods. One possibility is to equalize the periods at 5 years each (with no election to lengthen either period). The committee could then decide separately whether to make this equalizing rule prospective only or retroactive to one or more earlier years.

Another possibility would be to equalize the loss carryback and carryover periods (such as at 5 years each), but then to add a special rule permitting an 8 year carryback for losses sustained in taxable years before 1976. This type of rule would clearly benefit certain companies which the committee might feel have been adversely affected by the current recession, but would avoid the complexity involved in adopting a permanent elective carryback rule.

The committee might also wish to consider retaining the present loss carryover periods as they are under present law, but coupling them with a special, one-time, anti-recession eelction to allow extended carryback periods for operating losses received in certain taxable years before 1976. This approach would provide relief for businesses hard hit by the recession, while avoiding the technical problems which would arise with an extended carryback election for future years, and allowing (under the general rule) a sufficient carryover period for operating losses to be applied against the profits of successful businesses in future years.

If the committee decides to adopt some form of elective loss carryback, it might consider requiring reinvestment of the proceeds of a refund in the business operations, and continuation of the same business for some prescribed period of time. If these conditions are not satisfied, the refund benefits could be recaptured.

With regard to the problem of "trafficking" in loss carryovers by means of merging loss companies with profitable companies, one proposal is to limit a loss carryover after a reorganization to a portion of the acquiring or resulting company's income by reference to the basis of the loss company's assets in relation to the basis of all assets of the combined entity after the reorganization. Thus, for example, if a company with a loss carryover has a \$100,000 basis for its assets immediately before the company merges into a profitable company (whose assets have a basis of \$900,000), only 10 percent (\$100,000/\$1,000,000) of the loss carryover could be used after the merger against the income of the combined companies.

Finally, the committee may wish to consider making any liberalized loss carryback-carryover rules available to insurance companies in order to continue the parallel treatment regarding loss averaging which exists under the speical insurance company provisions in present law.

Messrs. Burke, Landrum, and Ketchum

Their proposal (H.R. 8737 and H.R. 8799) would allow taxpayers who have net operating losses to elect to substitute for the present carryforward period (generally 5 years) an extended carryback period (in addition to the 3-year period now available under the general rule). This would allow taxpayers to elect an 8-year carryback (with no carryforward).

Taxpayers receiving refunds of more than $10 million would be required to share them with their employees by contributing shares of their stock to an employee stock ownership plan ("ESOP").

Any taxpayer having outstanding loans guaranteed under the Emergency Loan Guarantee Act would be required to reduce the guaranteed loan balance by the amount of any refund received under the carryback election (less any amount paid to an ESOP). The company chiefly affected by the Emergency Loan Guarantee Act is Lockheed Aircraft Corporation.

The effective date of the proposal is for taxable years beginning after January 1, 1970.

The proposal also deals with the trafficking of loss carryovers from unprofitable corporations to profitable corporations by limiting a net operating loss carryover to that portion of the post-reorganization income clearly attributable to the business that suffered the losses. (This proposal would make no change in present rules relating to stock purchases (sec. 382(a)) or in the broad general rules of section 269).

Mr. Archer

The proposal would substitute a 10-year carryback-carryforward for the general rule of present law. A taxpayer would be allowed, subject to certain limitations, to select the 10-year period to which a loss occurred in a taxable year provided that such period consists of 10 consecutive years. The proposal would be applicable for losses incurred in taxable years beginning on or after January 1, 1970.

Mr. Vander Jagt

The proposal would provide an elective 10-year carryback period for deducting net operating losses provided the taxpayer surrenders its carryforward period. This proposal would apply to all business taxpayers whether the business is conducted as a sole proprietorship, partnership or corporation. The first loss year that this proposal would affect would be 1970, and the loss for any such year could not be carried back to taxable years ending prior to January 1, 1962.

With respect to the years 1970–1974, a recapture rule would apply to taxpayers that revoke their elections and an ESOP–SUB provision would also apply to those five years. The ESOP–SUB contributions under this election would be a deductible expense by the employer.

The proposal would also limit the "trafficking" in loss carryovers.

H. Personal Savings

Present law

Under present law, personal savings are made out of taxed income—that is, the income that individuals save is subject to individual income tax as is any investment income on such savings. In this respect, the income tax applies equally to income regardless of whether it is spent on consumption items or saved.

However, special tax treatment is accorded to certain income saved for retirement purposes under pension, profit-sharing, and other plans that qualitfy under the Internal Revenue Code and therefore do not discriminate in favor of highly paid employees and executives as compared with rank and file employees. Employees covered by such plans do not include their current income for tax purposes contributions made by their employers on their behalf to these plans. Instead, they postpone payment of tax until they receive the benefits, generally on retirement. In addition, investment earnings on the amounts contributed to qualified pension, etc., plans are exempt from tax when earned by the plan and are not taxed until they are paid out to the covered individuals, at which time they are taxed at the individual rates. This provides considerably more advantageous tax treatment to savings in qualified pension plans than to savings out of taxed income since it permits the employee covered by the pension plan to defer payment of tax for substantial periods of time. This deferral provides significant interest savings. Additionally, by deferring tax until the time that he receives the pension benefits, the covered individual generally reduces his tax since his income and hence applicable tax rates are generally lower at the time of retirement than during his working career. Also, if the covered individual dies before he receives the amounts he is entitled to, the remainder is not included in his estate even though it is payable to his heirs.

Since 1963, self-employed individuals may choose to be covered by so-called H.R. 10 plans if they provide comparable coverage and benefits for their employees. This permits self-employed people (including those who have no employees) to deduct limited contributions to a pension plan on their own behalf and to defer payment of tax on such retirement savings until they receive the benefits. Prior to the 1974 pension act, deductible pension contributions of the self-employed on their own behalf were limted to the lesser of 10 percent of earned income or $2,500 a year. The 1974 pension legislation raised this deductible amount for the self-employed to the lesser of 15 percent of earned income or $7,500 a year.

During the consideration of the 1974 pension act, it was brought to the attention of the Congress that only about one-half of the employees in private nonagricultural employment were covered by pension plans. As a result, the 1974 legislation allows individuals not covered by pension plans to set up individual plans for themselves (individual retirement accounts, or IRA's. Individuals are permitted to deduct their contributions to such IRA accounts up to the lesser of 15 percent of their earned income or $1,500 a year. The amounts placed in IRA accounts together with the investment earnings on these amounts remain free of tax until they are withdrawn, generally upon retirement, when they are included in the individual's tax income. This permits individuals establishing IRA accounts to receive much the same favored benefits accorded to individuals who are covered by employer-established pension plans.

Issues

Present concern about the possibility of capital shortages to meet the Nation's future needs has stimulated tax proposals designed both to increase personal savings and to provide greater equality in the tax treatment of saving. Such proposals would increase the deductible limits under IRA's and extend IRA's to employees covered by pension plans providing relatively little employer-financed benefits. These proposal also would extend the favorable tax treatment now provided for contributions to personal savings for other purposes.

The Administration has proposed the following changes, to take effect in 1977.

(1) Allowing individuals covered by employer pension plans (but where the employer contributions are below $1,500 a year) to establish IRA's. Such individuals would be able to deduct IRA contributions up to the difference between the maximum permissible IRA contribution (15 percent of earned income or $1,500 a year) and the employer's pension contribution made on their behalf.

(2) Raising the annual dollar limit on contributions to an IRA to $2,000 from its present level of $1,500.

(3) Exploring with the committee the possibility of establishing an IRA-like vehicle to encourage savings generally (for such purposes as the education of children, the purchase of a house, and provision for financial contingencies) rather than being aimed solely at retirement savings. As with IRA accounts, contributions to such an individual savings account (ISA) would be tax deductible up to some maximum and the investment income earned by the account would not be taxed currently. The proposal would include restrictions on how long the individual would be required to leave savings in the account before withdrawal and perhaps a threshold or floor on the amount deductible in order to be sure (to the extent possible) that the contributions represented extra savings and not just something that the individual would have saved anyway.

(*a*) *Proposals to increase limits on contributions to IRA's*

The Treasury proposal to increase the maximum deductible limits under IRA acconts is a reaction to the fact that the present annual limits on deductions to an IRA account (the lesser of 15 percent of earned income or $1,500) often are substantially lower than the annual 15 percent/$7,500 limits now applicable to deductible contributions of the self-employed on their own behalf to H.R. 10 plans, and are also lower than the present limits on contributions to qualified plans for employees generally. (In general, annual contributions on behalf of any individual under a defined contribution plan cannot exceed $25,000 a year (or 25 percent of compensation, if less) and the annual benefits paid to an individual under a defined benefit plan cannot exceed $75,000 a year (or 100 percent of compensation, if less).) Similarly, the proposal to make IRA's available to employees covered by pension plans with small employer contributions is intended to grant additional relief to such individuals.

A number of issues are involved in proposals to increase deductible contributions under the IRA provisions. Increasing the tax deduction for IRA accounts would involve substantial losses in revenue. The

Treasury estimates that its proposals to make IRA's available to those covered by "inadequate" pension plans would involve a revenue loss of roughly $500 million a year and that its proposal to increase the IRA limit to $2,000 a year would involve an additional revenue loss of some $300 million.

Substantial increases in the IRA limits could weaken employer financed plans by encouraging employers to curtail their plans and allow their employees who have the means to do so, to provide for their own retirement savings through the establishment of IRA's. For example, an individual employer who does not plan to set aside more than, e.g., $2,000 per year for his own retirement could, under the Treasury proposal, set up an IRA and provide for himself without providing any contribution for his employees. If he were to set up a regular pension plan, he would also have to provide benefits for his employees (as well as for himself) on a basis that does not discriminate in his own favor. Those holding this view argue that it is preferable to encourage provision for retirement through employer-financed qualified pension and profit-sharing plans which must not discriminate in favor of executives and highly paid employees as compared with rank and file employees. A counterargument is that, while self-employ individuals who wish to be covered by H.R. 10 plans must generally cover their employees, large numbers of self-employed individuals who have no employees have used H.R. 10 plans to provide pensions only for themselves.

Proposals to allow employees to establish IRA's for themselves if they are covered by plans which provide only modest employer contributions involve administrative difficulties if the maximum amount permitted to be contributed to the IRA is to be reduced by the amount of the employer contribution. This is because it would frequently be difficult to compute the amount of the employer contribution on behalf of any particular employee. On the other hand, if employees covered by pension plans were permitted to utilize the full amount of the IRA limit without any offset for employer pension contributions, they would be placed in a more advantageous position than other individuals utilizing IRA's. For this reason, proposals to allow employees covered by pension plans to set up IRA's for themselves sometimes seek to approximate the offset for the employer's pension contribution by considering the total annual employer's contribution to be proportional to covered compensation. Another variation would generally assume that the employer's contributions amount to a specified percentage of the employee's income.

The Treasury argues that IRA limits should be increased to reflect increases in prices. The Treasury first proposed the present $1,500 limit in December 1971; adjusting this limit for the 32-percent price inflation which has occurred since then would raise the limit to about $2,000. However, the legislation putting IRA into effect was not enacted until September 1974 and at that time the Congress presumably took price levels into consideration in establishing the $1,500 limit on IRA accounts. (The consumer price index has risen about 8 percent since the $1,500 limit was adopted; if this index were to be used, a corresponding upward adjustment in the annual dollar limit for IRA's would bring the dollar limit to $1,620.)

(b) *Proposals to allow deductions for savings for purposes other than retirement*

Deferred tax treatment for personal savings for purposes other than retirement (along the lines of the Treasury proposal to allow deductions for contributions to individual savings accounts) is supported on the ground that savings for such purposes as the education of children, the purchase of a home, and financial contingencies merit tax assistance just as much as retirement savings. However, the desirability of extending favored tax treatment to income saved for purposes other than retirement has been questioned.

There are practical grounds for the favorable tax treatment of pension savings financed by employer contributions that do not apply to other kinds of savings. To a very considerable extent, the present deferred tax treatment of employer contributions to qualified pension plans evolved in recognition of the practical difficulties of taxing covered employees currently on such contributions, particularly since employees may not actually receive benefits from pension plans until long after the contributions are made. A similar consideration for deferred treatment does not apply to the individual's own savings in such assets as bank accounts, stocks, and a house, since, as the owner, he has already received these assets.

Proposals to extend deferred tax treatment for income saved in ISA accounts for purposes other than retirement would involve a substantial revenue loss. The exact revenue loss would depend on the specifics of the program adopted.

Extending deferred tax treatment beyond the pension area to other individual savings out of income could fundamentally change the nature of the individual income tax. Any extension of deferred tax treatment to specific types of savings would create an additional precedent for extending similar treatment to other kinds of personal savings. (For example, deferred tax treatment for retirement savings under pension plans has been cited to support similar deferred treatment for the education of children or the purchase of a home.) Ultimately, such extensions could lead to a generalized deduction for savings which would tend to change the individual income tax from a tax on income to one on spending. This, it is argued, would be contrary to the principle of taxation based on the ability to pay since high income individuals save more than low income individuals and hence would receive larger tax deductions for personal savings. Such a tendency for savings deductions to favor high income individuals might be offset to some degree by placing relatively low maximums on the amount of savings eligible for tax deductions. However, experience has shown that there is a tendency for such maximum limitations on deductions to move upward.

(c) *Effectiveness of proposals in increasing savings*

There is also an important question as to how effective the proposed deferred treatment would be as a means of increasing the total volume of savings. For many years, economists have disputed whether changes in interest rates significantly affect the volume of personal savings and there appears to be a similar question as to the effectiveness of tax inducements as a means of stimulating such savings.

If the proposed deferred tax treatment were granted to personal savings without regard to whether such savings represented an increase over the amounts that would be saved in any event, much of the resulting revenue loss would be wasted since it would not have stimulated additional savings. The deductions could be restricted to those savings which are considered additional savings. However, such a procedure would be administratively difficult to put into practice. It would appear, for example, that the presence of such additional personal savings could be demonstrated only through a comparison of the individual's assets for successive years; it cannot be demonstrated merely by examining the size of savings in the particular savings items eligible for the deferred tax treatment because it would be possible for the taxpayer to shift his existing savings from those forms not eligible for the favored tax treatment to those forms which are eligible. (Even where the taxpayer's total personal savings increase from one period to another, it would be difficult to determine in individual cases whether this is a response to the favored tax treatment or whether it would have taken place in any event.)

Also, granting tax deductions for all savings involves problems of defining what constitutes savings. Additional administrative problems would also be created; the withholding system, for example, would have to be modified to take account of such deductions.

Additionally, whether an increase in personal savings is desirable depends to a considerable extent on the economic setting in the future. Perhaps the most important factor in encouraging total savings and the growth of capital is a generally prosperous and relatively high employment economy. Experience has shown that total savings are generally high when GNP is growing but that savings tend to drop in periods of recession. Therefore, the effectiveness of provisions to encourage personal savings through favored tax treatment may depend on the contribution that this tax treatment would make toward a prosperous and fully employed economy. If the economy is growing it may be appropriate to encourage greater savings to combat inflation; on the other hand, if the economy is faltering, attempts to encourage greater savings could merely depress the economy still further and reduce total saving.

An extreme illustration of the drastic impact that recession can have on savings is furnished by the experience in 1933, when gross savings were negligible and individuals actually dissaved (table 4). However, other examples of the dampening effect of recession on savings are furnished in the years 1949, 1954, 1957, 1970, and 1974. During these recession periods, the growth of personal money savings slowed down and in some cases money savings declined. These declines are greater when money savings are adjusted for inflation. For example, the very modest increase in money personal savings in 1974 over 1973 ($76.7 billion as compared with $74.4 billion) merely reflects inflation. After adjusting for a 10-percent increase in the GNP inflator, the 1974 savings figure is reduced to the neighborhood of $68 billion.

Moreover, even under the present tax treatment personal savings are assuming more importance as a source of capital. In recent years, the share of total private savings accounted for by personal savings has been rising while the share accounted for by gross business savings has been falling. In the 5-year period 1970–74, personal savings provided an average of 34.6 percent of total private savings as compared with an average of 26.2 percent in the 1960's and 30.4 percent in the 1950's (see tables 4 and 5). Similarly, in the years 1970–74, personal savings amounted to 7.7 percent of personal disposable income and 5.4 percent of GNP—significantly higher than the comparable figures of 6 percent of disposable income and 4.1 percent of GNP in the 1960's and 6.7 percent of personal disposable income and 4.7 percent of GNP in the 1950's (tables 6 and 7).

Alternative Proposals

Mr. Corman

The proposal would allow employees to deduct their contributions to qualified plans up to 15 percent of their earned income, or $1,500 a year (whichever is less), with an offset for the amount of employer contributions on their behalf. The deductions would be allowed only with respect to contributory plans presently in existence. Government employees would be specifically excluded from the deductions for employee contributions to pension plans.

Mr. Archer

The proposal would allow an exclusion from gross income of up to $1,000 ($2,000 for those filing joint returns) for qualified savings and investments made during the taxable year.

TABLE 4.—SOURCES OF GROSS SAVING, 1929–75 (I AND II QUARTERS)

[Billions of dollars]

Year or quarter	Gross private saving and government surplus or deficit, national income and product accounts						
		Private saving			Government surplus or deficit (−)		
	Total	Total	Personal saving	Gross business saving	Total	Federal	State and local
1929	16.3	15.3	4.2	11.2	1.0	1.2	−0.2
1933	.9	2.3	−.9	3.2	−1.4	−1.3	−.1
1939	8.8	11.0	2.6	8.4	−2.2	−2.2	(1)
1940	13.6	14.3	3.8	10.5	−.7	−1.3	.6
1941	18.6	22.4	11.0	11.4	−3.8	−5.1	1.3
1942	10.7	42.0	27.6	14.5	−31.4	−33.1	1.8
1943	5.5	49.7	33.4	16.3	−44.1	−46.6	2.5
1944	2.5	54.3	37.3	17.1	−51.8	−54.5	2.7
1945	5.2	44.7	29.6	15.1	−39.5	−42.1	2.6
1946	35.1	29.7	15.2	14.5	5.4	3.5	1.9
1947	42.0	27.5	7.3	20.2	14.4	13.4	1.0
1948	49.9	41.4	13.4	28.0	8.5	8.4	.1
1949	35.9	39.0	9.4	29.7	−3.2	−2.4	−.7
1950	50.4	42.5	13.1	29.4	7.9	9.1	−1.2
1951	56.1	50.3	17.3	33.1	5.8	6.2	−.4
1952	49.5	53.3	18.1	35.1	−3.8	−3.8	(2)
1953	47.5	54.4	18.3	36.1	−6.9	−7.0	.1
1954	48.5	55.6	16.4	39.2	−7.0	−5.9	−1.1
1955	64.8	62.1	15.8	46.3	2.7	4.0	−1.3
1956	72.7	67.8	20.6	47.3	4.9	5.7	−.9
1957	71.2	70.5	20.7	49.8	.7	2.1	−1.4
1958	59.2	71.7	22.3	49.4	−12.5	−10.2	−2.3
1959	73.8	75.9	19.1	56.8	−2.1	−1.2	−.8
1960	77.5	73.9	17.0	56.8	3.7	3.5	.2
1961	75.5	79.8	21.2	58.7	−4.3	−3.8	−.5
1962	85.0	87.9	21.6	66.3	−2.9	−3.8	.9
1963	90.5	88.7	19.9	68.8	1.8	.7	1.2
1964	101.0	102.4	26.2	76.2	−1.4	−3.0	1.7
1965	115.3	113.1	28.4	84.7	2.2	1.2	1.0
1966	124.9	123.8	32.5	91.3	1.1	−.2	1.3
1967	119.5	133.4	40.4	93.0	−13.9	−12.4	−1.6
1968	128.3	135.2	39.8	95.4	−6.8	−6.5	−.3
1969	144.0	135.2	38.2	97.0	8.8	8.1	.7
1970	143.1	153.2	56.2	97.0	−10.1	−11.9	1.8
1971	152.2	170.7	60.5	110.2	−18.5	−21.9	3.4
1972	173.3	178.5	52.6	125.9	−5.1	−17.5	12.3
1973	214.4	210.9	74.4	136.5	3.5	−5.6	9.2
1974	207.5	213.8	76.0	136.8	−6.3	−8.1	1.8
1975-I	170.6	222.6	75.9	146.7	−56.0	−54.4	−1.6
1975-II	165.0	269.2	113.8	155.4	−104.2	−103.3	−.9

[1] Surplus of $32 million.
[2] Deficit of $41 million.

Source: Department of Commerce, Bureau of Economic Analysis.

TABLE 5.—PERSONAL SAVINGS COMPARED WITH GROSS BUSINESS SAVINGS AS A PERCENT OF TOTAL PRIVATE SAVINGS

Year	Personal savings	Gross business savings	Total private savings
1929	27.5	73.5	100
1933	−39.1	139.1	100
1939	23.6	76.4	100
1940	26.6	73.4	100
1941	49.1	50.9	100
1942	65.7	34.3	100
1943	67.2	32.8	100
1944	68.7	31.3	100
1945	66.2	33.8	100
1946	51.2	48.8	100
1947	26.5	73.5	100
1948	32.4	67.6	100
1949	24.1	75.9	100
1950	30.8	69.2	100
1951	34.4	65.6	100
1952	34.0	66.0	100
1953	33.6	66.4	100
1954	29.5	71.5	100
1955	25.4	74.6	100
1956	30.4	69.6	100
1957	29.4	70.6	100
1958	31.1	68.9	100
1959	25.2	74.8	100
1960	23.0	67.0	100
1961	26.6	73.4	100
1962	24.6	75.4	100
1963	22.4	77.6	100
1964	25.6	74.4	100
1965	25.1	74.9	100
1966	26.3	73.7	100
1967	30.3	69.7	100
1968	29.4	70.6	100
1969	28.3	71.7	100
1970	36.7	63.3	100
1971	35.4	64.6	100
1972	29.5	70.5	100
1973	35.3	64.7	100
1974	36.0	64.0	100
1975–I	34.1	65.9	100
1975–II	42.3	57.7	100

Source: Based on data supplied by Department of Commerce, Bureau of Economic Analysis.

TABLE 6.—PERSONAL SAVINGS COMPARED WITH GROSS BUSINESS SAVING AS A PERCENT OF GROSS NATIONAL PRODUCT

Year	Personal savings	Gross business saving	Total private savings
1929	4.1	10.9	14.8
1933	−1.6	5.8	4.1
1939	2.9	9.3	12.3
1940	3.8	10.5	14.3
1941	8.8	9.2	18.0
1942	17.5	9.2	26.6
1943	17.4	8.5	25.9
1944	17.8	8.1	25.8
1945	14.0	7.1	21.1
1946	7.3	7.0	14.2
1947	3.2	8.7	11.9
1948	5.2	10.9	16.1
1949	3.7	11.6	15.2
1950	4.6	10.3	14.9
1951	5.3	10.1	15.3
1952	5.2	10.2	15.4
1953	5.0	9.9	14.9
1954	4.5	10.7	15.2
1955	4.0	11.6	15.6
1956	4.9	11.3	16.2
1957	4.7	11.3	16.0
1958	5.0	11.0	16.0
1959	3.9	11.7	15.7
1960	3.4	11.3	14.7
1961	4.1	11.3	15.3
1962	3.9	11.8	15.7
1963	3.4	11.7	15.0
1964	4.1	12.1	16.2
1965	4.1	12.4	16.5
1966	4.3	12.2	16.5
1967	5.1	11.7	16.8
1968	4.6	11.0	15.6
1969	4.1	10.4	14.5
1970	5.8	9.9	15.7
1971	5.3	9.2	14.5
1972	4.5	10.9	15.4
1973	5.7	10.5	16.3
1974	5.5	9.8	15.3
1975–I	5.4	10.4	15.7
1975–II	7.9	10.8	18.6

Source: Based on data supplied by the Department of Commerce, Bureau of Economic Analysis.

TABLE 7.—DISPOSITION OF PERSONAL INCOME, 1929-75 (I AND II QUARTERS)

Year of quarter	Personal income	Less: Personal tax and nontax payments	Equals: Disposable personal income	Less: Personal outlays — Total	Less: Personal outlays — Personal consumption expenditures	Less: Personal outlays — Interest paid by consumers	Less: Personal outlays — Personal transfer payments to foreigners	Equals: Personal saving	Percent of disposable personal income — Personal outlays — Total	Percent of disposable personal income — Personal outlays — Consumption expenditures	Percent of disposable personal income — Personal saving
	Billions of dollars								Percent		
1929	85.9	2.6	83.3	79.1	77.2	1.5	0.3	4.2	95.0	92.7	5.0
1933	47.0	1.5	45.5	46.5	45.8	.5	.2	−.9	102.0	100.6	−2.0
1939	72.8	2.4	70.3	67.7	66.8	.7	.2	2.6	96.3	95.0	3.7
1940	78.3	2.6	75.7	71.8	70.8	.8	.2	3.8	94.9	93.6	5.1
1941	96.0	3.3	92.7	81.7	80.6	.9	.2	11.0	88.2	86.9	11.8
1942	122.9	6.0	116.9	89.3	88.5	.7	.1	27.6	76.4	75.7	23.6
1943	151.3	17.8	133.5	100.1	99.3	.5	.2	33.4	75.0	74.4	25.0
1944	165.3	18.9	146.3	109.1	108.3	.5	.4	37.3	74.5	74.0	25.5
1945	171.1	20.9	150.2	120.7	119.7	.5	.5	29.6	80.3	79.7	19.7
1946	178.7	18.7	160.0	144.8	143.4	.8	.7	15.2	90.5	89.6	9.5
1947	191.3	21.4	169.8	162.5	160.7	1.1	.7	7.3	95.7	94.6	4.3
1948	210.2	21.1	189.1	175.8	173.6	1.5	.7	13.4	92.9	91.8	7.1
1949	207.2	18.6	188.6	179.2	176.8	1.9	.5	9.4	95.0	93.8	5.0
1950	227.6	20.7	206.9	193.9	191.0	2.4	.5	13.1	93.7	92.3	6.3
1951	255.6	29.0	226.6	209.3	206.3	2.7	.4	17.3	92.4	91.0	7.6
1952	272.5	34.1	238.3	220.2	216.7	3.0	.4	18.1	92.4	90.9	7.6
1953	288.2	35.6	252.6	234.3	230.0	3.8	.5	18.3	92.8	91.1	7.2
1954	290.1	32.7	257.4	241.0	236.5	4.0	.5	16.4	93.6	91.9	6.4
1955	310.9	35.5	275.3	259.5	254.4	4.7	.5	15.8	94.3	92.4	5.7
1956	333.0	39.8	293.2	272.6	266.7	5.4	.6	20.6	93.0	91.0	7.0
1957	351.1	42.6	308.5	287.8	281.4	5.8	.6	20.7	93.3	91.2	6.7
1958	361.2	42.3	318.8	296.6	290.1	5.9	.6	22.3	93.0	91.0	7.0
1959	383.5	46.2	337.3	318.3	311.2	6.5	.6	19.1	94.4	92.3	5.6
1960	401.0	50.9	350.0	333.0	325.2	7.3	.5	17.0	95.1	92.9	4.9
1961	416.8	52.4	364.4	343.3	335.2	7.6	.5	21.2	94.2	92.0	5.8
1962	442.6	57.4	385.3	363.7	355.1	8.1	.5	21.6	94.4	92.2	5.6
1963	465.5	60.9	404.6	384.7	375.0	9.1	.6	19.9	95.1	92.7	4.9
1964	497.5	59.4	438.1	411.9	401.2	10.1	.6	26.2	94.0	91.6	6.0
1965	538.9	65.7	473.2	444.8	432.8	11.3	.7	28.4	94.0	91.5	6.0
1966	587.2	75.4	511.9	479.3	466.3	12.4	.6	32.5	93.6	91.1	6.4
1967	629.3	83.0	546.3	506.0	492.1	13.2	.7	40.4	92.6	90.1	7.4
1968	688.9	97.9	591.0	551.2	536.2	14.3	.8	39.8	93.3	90.7	6.7
1969	750.9	116.5	634.4	596.2	579.5	15.8	.9	38.2	94.0	91.3	6.0
1970	808.3	116.6	691.7	635.5	617.6	16.8	1.0	56.2	91.9	89.3	8.1
1971	864.0	117.6	746.4	685.9	667.1	17.7	1.1	60.5	91.9	89.4	8.1
1972	944.9	142.4	802.5	749.9	729.0	19.8	1.1	52.6	93.4	90.8	6.6
1973	1,055.0	151.3	903.7	829.4	805.2	22.9	1.3	74.4	91.8	89.1	8.2
1974	1,150.5	170.8	979.7	902.7	876.7	25.0	1.0	77.0	92.2	89.4	7.9
1975–I	1,193.4	178.0	1,015.5	939.5	913.2	25.4	.9	75.9	92.5	89.9	7.5
1975–II	1,220.5	142.0	1,078.5	964.7	938.6	25.2	.9	113.8	89.4	87.0	10.7

Source: Department of Commerce, Bureau of Economic Analysis.

I. Swedish Investment Reserve

Description

A company may set aside in one year up to 40 percent of net income before taxes. Of this amount, 46 percent must be deposited in a special, blocked, noninterest-bearing account with the Swedish National Bank. Generally, the reserve may be drawn upon only with the consent of, or on direction from, the Government's Labor Market Board. These set aside funds are permanently exempted from income taxation. When funds have been deposited in the reserve longer than 5 years, 30 percent may be withdrawn for investment without official permission. When funds are withdrawn from the reserves with official permission, 10 percent of the amount used is allowed as a deduction from taxable income. If some part of the reserve is used without permission, or the instructions to use the reserve are not followed, then the part of the reserve involved and a 10-percent penalty will be included in net taxable income.

Investment activities for which the investment reserve can be used include a broad variety of expenditures for ships, buildings, machinery and equipment, repairs to ships and buildings and residences, export promotion and holding unsold inventories. Investment expenditures for these activities during the approved time periods are eligible for 100-percent depreciation for that year. Thus, expensing the investment and the 10-percent deduction allowed for following instructions to invest provide the taxpayer with a deduction of 110 percent of the cost of the investment.

Evaluation

The Swedish investment reserve provides an additional 17 percent in after-tax cash flow on the 40 percent of a firm's net income that it agrees to set aside. This results because only 46 percent of the set-aside currently is lost to the company as it is deposited with the central bank in contrast with the 54-percent tax liability on those funds that would be paid to the Swedish Government if the firm did not participate in the reserve plan.

When funds are withdrawn from the reserve at the instruction of the Labor Market Board, the firm receives a 110-percent deduction, in effect, for the investment expenditures. The part of the investment paid for by the release from the reserve fund is use of untaxed funds from a previous year's income. While this portion of the investment cost may not be depreciated, the funds spent on the investment in effect were a deduction that reduced taxable income in the year of the set-aside. The remaining cost of the investment is expensed in the year of expenditure. On top of this, there is the 10-percent investment bonus deduction.

Substantial incentive to use the investment reserve apparently exists. In the 15-year period 1956–1971, there were four recession periods when releases of investment funds were authorized. Table 8 shows that the investment funds, as a percentage of total private investment, were considerably higher in the periods of release than in years immediately before or after release periods.

This is a desirable effect in terms of economic stabilization policy, because it reduces the amplitude of fluctuations between boom and bust. To be successful, the funds should be released as soon as the recession is evident, and should be cut off when the recovery has started and the normal economic forces can maintain the momentum of the recovery. Students of the Swedish economy believe that the periods of the releases have been well timed except that the end of the release periods in 1959 and 1971 merged into the recovery period; in effect, they came a bit too late.

The Swedish Government has not always allowed firms full freedom in investment choices. In 1971, for example, releases were allowed on a selective basis; releases authorized in recovery and boom periods often have been earmarked for investment in depressed industries or localities.

The portion of the set-aside that must be deposited in the central bank deposit is less than the corporation income tax that would otherwise have been paid on that portion of the income. This is, in fact, a tax reduction in a boom period, and even though a sweetener may be needed to convince firms to participate in the reserve plan, it does not appear to be worth the cost of a tax reduction at that phase of the cycle.

In addition to the investment reserve, the Swedish Government uses labor market policies, monetary policy, and both the spending and tax functions of fiscal policy to influence cyclical economic behavior. In the tax area, an investment tax has been put into effect in booms and withdrawn in recessions. In combination with the investment reserve funds, tax policy has been effective in stimulating investment in depressions, but it has been somewhat less effective as a deterrent in dooms because the investment reserve fund provides a net reduction in the basic corporate tax rate that about halves the effect of the investment tax.

Relevance to the United States

Firms voluntarily make set-asides in the investment reserve and the Swedish Government does not require a company to make such deposits during a boom to control inflation. The 17-percent increase in available cash flow from making a set-aside may be more of an incentive to business firms to participate in the plan than the 110-percent effective first-year writeoff of investment expenditure in the future. The investment reserve plan, however, has been effective as an investment stimulus during recessions this may well have been the major objective of the program.

The relative ineffectiveness of the investment reserve fund as an anti-inflation tool is indicated by the need of the Swedish Government to resort to other programs to control economic cycles: impose an investment tax in booms and rescind it in recessions; public expenditure programs directed at controlling the cyclical patterns in public work activities and residential construction; vocational and geographic labor mobility programs; and a form of public service employment.

The reserve funds also offset the effects of monetary policy and complicate budgetary finance. A firm that makes a deposit in the boom increases its working capital by 17 percent, and the government receives no tax payments on the amount of taxable income involved in the decision. While the government can borrow the difference in the money market, it incurs an interest charge on the increased debt. The firm, on the other hand, benefits from an increased cash flow without having had to face the competitive evaluation of its credit needs in the money market or to pay interest on the funds. During the recessions, the firm is better off in not having to borrow money if it is authorized to withdraw funds from its reserve deposit. Swedish economists have pointed out that the firms most likely to be in this position would be those which were highly profitable in the preceding boom and able to afford the set-aside. Funds withdrawn from the reserve deposit are, in effect, an interest-free loan since the funds otherwise would have been paid in taxes and been unavailable to the firm. Otherwise, there is no substantial difference whether the reserve deposit in the central bank is used to finance investment by business or by government. The plan is deficient, however, as an inflationary control.

Release of funds from reserve deposits is authorized by the Labor Market Board. It is an agency that is sensitive to employment fluctuations and may be the most effective instrument for this purpose. Its decisions are final with respect to the amount to be released, the firms affected, and whether the release is available generally for all investment opportunities or is to be directed at specific industries and/or geographic areas. No such agency exists in the United States Government, and it is questionable whether Congress would consent to endowing an agency with so broad a range of discretion.

Sweden is a relatively small country, and the number of firms that would be involved in these decisions is quite small relative to the United States. The numbers involved and the complexity of the problems create doubts whether it is desirable in this country.

If the United States would consider enacting an identical investment reserve program, changes in fiscal and monetary policies would be needed unless investment reserves funds were to be treated as additions to the existing complex of policies. In the course of a boom, the Federal Government would need to increase its receipts by the amount foregone. If taxes are raised by the same amount, the relative tax burden on other firms and on individuals would be increased. The banking system could lend the money, if debt would be used to finance the revenue loss, so long as the central bank increased reserves by a large enough amount to offset the deposit in the blocked account.

During a recession if Federal Government fiscal policies would be supplemented by release of funds from the investment reserve, the budget deficit would be increased by the shortfall of receipts attributed to the amount of new investment eligible for 100 percent depreciation in the first year. This deficit would be offset partly as individual income and other tax receipts increase from the investment stimulus. Monetary policy would have to accommodate the increased Federal deficit, but the withdrawal of reserves from the blocked account would reduce the increase in the money supply needed to recover from the recession.

TABLE 8.—YEARLY RELEASES FROM INVESTMENT FUNDS

Year	Million Swedish Krona [1]	Main period of release	Percent of total private investment
1956	0.6		0.2
1957	.2		.01
1958	29.9	May 1958–September 1959	.54
1959	308.8		5.09
1960	381.0		5.41
1961	172.4		2.12
1962	170.6	May 1962–March 1964	1.96
1963	644.6		7.01
1964	313.6		3.15
1965	227.5		2.03
1966	302.9		2.34
1967	536.3	May 1967–March 1969	4.11
1968	1,421.2		11.47
1969	730.4		5.63
1970	368.7		2.58
1971	988.5	July 1971–December 1971	6.35

[1] Swedish Krona. Approximate dollar figures are obtained by dividing by 5 or 4, depending on whether the "old" or the "new" dollar rate is regarded as more relevant for a comparison.

Source: Assar Lindbeck, "Some Fiscal and Monetary Policy Experiments in Sweden," in Credit Allocation Techniques and Monetary Policy, Federal Reserve Bank of Boston, 1973, p. 193.

J. Other Proposals

Messrs. Waggonner and Conable

The proposal would increase the amount a corporation may accumulate before its retained earnings may be subject to the accumulated earnings tax from $150,000 to $250,000. In addition, the proposal would allow corporate shareholders to defer tax on dividends paid or payable to them to the extent they reinvest the amount received in the corporation within 45 days from the date the dividend becomes payable. Any tax deferred as a result of this provision would be recaptured on any disposition of the stock.

Mr. Jones

In the area of energy, the proposal would include geological and geophysical expenses as intangible drilling expenses and would also include geothermal energy both as an intangible drilling expense and as subject to a percentage depletion allowance.

Messrs. Schneebeli and Ketchum

The proposal would treat pollution control expenditures as an ordinary and necessary expense of conducting a trade or business under section 162 of the code.

Mr. Steiger

The proposal would permit taxpayers to treat the cost of meeting Federal Occupational Safety and Health Standards for tax purposes in a manner similar to that of costs of pollution control and abatement devices.

Messrs. Archer and Vander Jagt

The proposal would provide for employee stock ownership plan financing. Mr. Vander Jagt proposes to consider various alternatives to encourage greater employee ownership interest including amendments relating to stock ownership plans, stock bonus plans, and deductibility of certain employee investment in employer securities.

Mr. Crane

He would allow a reduction of increases in inventory valuation by the rate of inflation.

Messrs. Archer, Crane, and Ketchum

These members asked that H.R. 7240 and H.R. 8053, the "Jobs Creation" bill be reviewed by the committee in its consideration of capital formation proposals. The pertinent provisions of the bill for tax reform, phase one involves tax credits for individual savings and investments, exclusions from income of amounts received by individuals as dividends, limited exclusions for individuals of certain capital gains, adjustments in corporate normal taxes, increases in investment credit, increases in the corporate surtax exemption, annual price level adjustments, increases in class life variances for purposes of depreciation and rapid amortization of pollution control facilities.

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