ECONOMIC AND ENERGY MEETING

Tuesday, June 17, 1975

2:00 P. M.

THE PRESIDENT HAS SEEN....

June 17, 1975

TAX REFORM RECOMMENDATIONS AND OPTIONS

General Strategy

EPB Recommendation: Testify on the Labor-Management Committee utility proposals at the same time as the Administration testimony on tax reform but as a separate subject and request that the Ways and Means Committee consider the utility proposals first and as a separate package.

Agree ______________ Disagree ______________

Reproposal of 1973 Tax Reform Package

EPB Recommendation: Re-endorse those provisions of last year's bill which were based on the Administration's proposals (Minimum Taxable Income, Limitation on Artificial Accounting Losses, Simplification, Elimination of Foreign Withholding)

Agree GRF Disagree ______________

EPB Recommendation: Endorse the capital gains provisions as contained in last year's Ways and Means Committee bill which would constitute a net liberalization of the capital gains tax.

Agree GRF Disagree ______________

EPB Recommendation: Propose to restrict the use of tax exempt bonds for pollution control and industrial development purposes, as a tactical manuever to fend off efforts to further liberalize these provisions.

Agree GRF Disagree ______________

EPB Recommendation: Not repropose provisions on foreign taxation, property tax relief for the elderly, tuition credits for private schools, and taxable municipals.

Agree GRF Disagree ______________

Budget Decisions

EPB Recommendation: Oppose re-enactment of the 1975 Tax Reduction Act provisions on a permanent basis.

Agree ____________ Disagree ____________

EPB Recommendation: Treasury should proceed to design a capital formation package which would be phased in over a period of years so that the revenue loss in the first year will be bwtween $2 and $3 billion.

Agree GRF Disagree ____________

EPB Recommendation: The revenue effects of the utility proposals should be presented as part of the total energy package, with the revenue loss to be made up from energy tax revenues.

Agree GRF Disagree ____________

Potential Revenue Gainers

EPB Recommendation: Support retention of DISC at this time.

Agree GRF. Disagree ____________

Alcohol and Tobacco Tax Options

Option A ________ Propose a significant increase in these taxes perhaps 50 percent--and at the same time propose that they be recast as *ad valorem* taxes (i.e., percentages of value), so that they will increase automatically in the future and not get "out of date" as the present taxes have.

Supported by: Treasury, Labor

Option B GRF. Propose no increase or only a slight increase in the present level of these taxes but propose that they be recast as *ad valorem* taxes, so that they will help offset future deficits.

Supported by: CEA, Commerce

Capital Formation Measures

EPB Recommendation: Indicate our desire to work with the Ways and Means Committee on capital formation measures.

Agree __________ Disagree __________

Recommendation: That Treasury raise the issue of the failure of business to use tax depreciation for financial purposes in their testimony on tax reform without actually endorsing a proposal to require business to use tax depreciation for financial purposes.

Agree __________ Supported by: DOL, Treasury, DOC

Disagree __________ Supported by:

THE WHITE HOUSE
WASHINGTON

Jim -

This duplicates one decision made in Treasury letter --

Should it be combined in one memo or handled separately?

Trudy

Combine in one memo

THE WHITE HOUSE

WASHINGTON

June 18, 1975

NOTE FOR JIM CONNOR

FROM: ROGER PORTER RP

The President handed the attached to Mr. Seidman following the Economic and Energy meeting. He passed it on to me to send to you for your files.

Attachment

THE WHITE HOUSE

WASHINGTON

June 18, 1975

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR: L. WILLIAM SEIDMAN

FROM: JAMES E. CONNOR

SUBJECT: TAX REFORM PLANS AND OPTIONS

The following Tax Reform Recommendations and Options submitted by the Economic Policy Board have been reviewed and approved by the President.

Reproposal of 1973 Tax Reform Package

Re-endorse those provisions of last year's bill which were based on the Administration's proposals (Minimum Taxable Income, Limitation on Artificial Accounting Losses, Simplification, Elimination of Foreign Withholding.

Endorse the capital gains provisions as contained in last year's Ways and Means Committee bill which would constitute a net liberalization of the capital gains tax.

Propose to restrict the use of tax exempt bonds for pollution control and industrial development purposes, as a tactical manuever to fend off efforts to further liberalize these provisions.

Not repropose provisions on foreign taxation, property tax relief for the elderly, tuition credits for private schools, and taxable municipals.

Budget Decisions

Treasury should proceed to design a capital formation package which would be phased in over a period of years so that the revenue loss in the first year will be between $2 and $3 billion.

The revenue effects of the utility proposals should be presented as part of the total energy package, with the revenue loss to be made up from energy tax revenues.

Potential Revenue Gainers

Support retention of DISC at this time.

Alcohol and Tobacco Tax Options

Option B - Propose no increase or only a slight increase in the present level of these taxes but propose that they be recast as ad valorem taxes, so that they will help offset future deficits.

Capital Formation Measures

Indicate our desire to work with the Ways and Means Committee on capital formation measures.

That Treasury raise the issue of the failure of business to use tax depreciation for financial purposes in their testimony on tax reform without actually endorsing a proposal to require business to use tax depreciation for financial purposes.

Regarding Budget Decisions the following recommendation was questioned by the President:

Oppose re-enactment of the 1975 Tax Reduction Act provisions on a permanent basis.

Secretary Simon's memorandum on the above subject was also reviewed by the President and the following decisions were approved:

Alcohol and Tobacco Taxes

Option B Propose no increase or only a slight increase in the present level of these taxes but propose that they be recast as ad valorem taxes, so that they will help offset future deficits.

Depreciation: A Special Problem

That we advert to this problem in our July presentation by stating that Congress may wish to continue something along these lines, without actually endorsing such a proposal. This would get the idea out for discussion and give the business community an opportunity to focus on the problem over the summer and before the Committee begins markup in the fall.

Please follow-up with appropriate action.

cc: Don Rumsfeld

THE PRESIDENT HAS SEEN.

THE WHITE HOUSE

WASHINGTON

June 16, 1975

ECONOMIC AND ENERGY MEETING
June 17, 1975
2:00 p.m.
Cabinet Room

From: L. William Seidman

I. PURPOSE

To review tax reform plans and options.

II. BACKGROUND, PARTICIPANTS AND PRESS PLAN

A. Background: In your State of the Union Message you indicated that you would submit to the Congress later in the year tax reform proposals. The House Ways and Means Committee is preparing to commence consideration of tax reform. The EPB Executive Committee has held several sessions in recent weeks on the issue of tax reform. Attached at Tab C is a memorandum prepared by the Department of the Treasury which reviews the outlook for tax reform, the elements of the 1973 tax reform package, budget decisions associated with the Tax Reduction Act of 1975 and tax reform proposals, possible revenue gaining tax provisions and capital formation measures. This meeting will focus exclusively on the tax reform issue.

The Weekly Economic Fact Sheet is attached at Tab A. The Economic Policy Board Weekly Report is attached at Tab B.

B. Participants: The Vice President, William E. Simon, L. William Seidman, John T. Dunlop, Alan Greenspan, Rogers C.B. Morton, Arthur F. Burns, Frank G. Zarb, Donald Rumsfeld, Paul O'Neill, Richard Dunham, Frederick Hickman.

C. Press Plan: White House Press Corps Photo Opportunity.

III. AGENDA

A. Tax Reform Plans and Options

Secretary Simon will review tax reform plans and options. See Tab C.

A

June 16, 1975

WEEKLY ECONOMIC FACT SHEET

Production

- Real GNP fell at an 11.3 percent annual rate during the first quarter, but the basic picture of firm final sales and a rapid inventory correction continues. Consumer expenditures rose at a 2.5 percent annual rate in real terms.

- Business inventories fell $1.9 billion in April, an all-time record, continuing the rapid pace of inventory decumulation from the first quarter.

- Industrial production declined by 0.3 percent in May, roughly the same rate of decline as in April. Consumer goods production increased; business equipment and materials production declined.

Employment and Unemployment

- Although the rate of unemployment rose by 0.3 percent to 9.2 percent in May, total employment rose slightly for the second consecutive month. The rise in unemployment stemmed from a large increase in the labor force.

Prices

- Consumer prices rose by 0.6 percent in April, bringing the rate of increase over the past three months to a 5.8 percent annual rate, less than one-half of the 12.2 percent rate of the last six months of 1974.

- Wholesale prices rose by 0.4 percent in May. Farm commodity prices continued to advance but industrial commodity prices rose by only 0.2 percent last month, further confirming the abatement in inflation. The wholesale price index has declined at a 1.3 percent annual rate during the past six months.

Money and Financial

- The money supply is growing at a rapid rate. During the last three months the money supply (M_1) grew at an annual rate of about 9.5 percent, which was higher than the 4.4 percent rate of increase of the last 12 months. The broader money measure (M_2) has also risen more rapidly in the last three months than in the previous year.

Key Sectors of the Economy

- Sales of domestic automobiles have picked up considerably in recent weeks. Based on the figures for the first 10 days of June, domestic auto sales may reach 623 thousand units in June, which will match the scheduled auto production for the month. In April and May, domestic sales fell short of auto production resulting thereby in inventory buildup.

- Sales of single-family houses jumped 25% in April, bringing the inventory sales ratio to the lowest level since June 1973. The May figures for housing starts and permits will be released tomorrow. Savings flows into the thrift institutions were at record levels in May. S&L's received $3.8 billion, greater than in any other month in history, reflecting deposits of income tax rebates.

- New orders for durable goods rose strongly in April by ten percent. The new order series is volatile but this is the second increase in the past three months. New orders for capital goods also rose by a surprisingly strong ten percent.

- The Department of Commerce survey of business investment intentions indicates that business investment plans for the second half of the year have been scaled downward, but the reductions are still moderate and unsurprising.

B

June 16, 1975

ECONOMIC POLICY BOARD WEEKLY REPORT

<u>Issues Considered by EPB During Week of June 9</u>

1. Northeast/Midwest Rail Restructuring
   Draft memorandum reviewed. DOT to put memorandum into final form for consideration at the June 10 meeting with the President.

2. Economic Aspects of Revised Energy Plan
   FEA, OMB, and Treasury are preparing a reconstruction of the budgetary estimates of the revised energy program.

3. Grain Reserves
   A working group meeting of the International Food Review Group (IFRG) to prepare options paper on grain reserves for consideration next week by the IFRG.

4. SEC and Bank Disclosures
   Memorandum on SEC/Bank Disclosure Dispute Concerning Required Disclosure in Bank Holding Company Registration Statements reviewed. Treasury to keep EPB informed of future developments.

5. New York City Financial Situation
   Treasury to prepare memorandum for the President on the current status of the New York City financial situation.

6. Tax Reform
   Treasury to prepare revised memorandum for consideration at June 17 meeting with the President.

<u>Major Upcoming Agenda Items</u>

1. Food Deputies Report

2. Extension of Council on Wage and Price Stability Legislation

3. Labor-Management Committee proposed task force to expedite utility construction

4. Antitrust Immunities Task Force Report

5. Fertilizer Task Force Report

6. National Commission on Productivity and Work Quality monthly status report

7. Sugar options paper

C

MEMORANDUM FOR THE PRESIDENT

Subject: Tax Reform Plans and Options

I. OUTLOOK

Mr. Ullman proposes to have the Ways and Means Committee commence consideration of tax reform on Monday, June 23, just before the Congressional recess starting June 27.

Treasury has been asked whether we wish to appear the first two days, but we are not being pressed to do so. Alternatively, it appears to be open to us to appear on July 7 or 8, immediately after the recess. If we do not appear on June 23, the first week may be taken up with a briefing for new members or with expert panels on broad tax reform subjects--or possibly the entire process will be deferred until July 8.

The Committee is expected to concentrate on a limited number of issues, in order to keep the subject manageable and get out a bill promptly. At present, Dr. Woodworth expects that the principal items considered will be those contained in the bill which the Committee adopted at the end of the last Congress but never reported. That bill was built around the package of proposals which the Administration presented in April 1973, with the usual compromises, deletions and additions. The bill runs to several hundred pages and took a number of months for the Committee to complete.

In general, our plan has been to update and repropose most of our 1973 package of tax reform and then to make additional proposals addressed to the problems of "capital formation."

There is considerable Congressional interest in the subject of "capital formation," but it is not clear that all members of the Committee are very interested in that subject nor that even a majority of the members are interested in dealing with it immediately. Mr. Ullman has talked about wanting to do something about "capital formation," but has been equivocal about whether he sees that as part of an initial tax reform package, or as a subsequent effort. To the extent that the Committee feels pressure to produce a tax reform package at an early date, it may wish to concentrate on the kinds of items which it adopted last year, leaving the broader and more difficult subject of capital and capital formation to a later stage.

Senator Long has recently been quoted as saying he thinks we should "do something" about capital formation, but has served notice that any major benefits for business will need to be wrapped in a "populist" package.

The danger in separating the capital issue from tax reform is that the drive to do something with the issue will be diminished once a tax reform package has been enacted, and any revenues raised from tax reform will likely be dissipated for other purposes. Thus, if we do wish to make affirmative proposals in the capital area, we should strive to get such proposals considered as part of the initial tax reform package.

As to the capital issue, the Treasury has been particularly interested in proposals that would reduce or eliminate the present two-tier tax on corporate income. The ultimate objective is to tax income only once, either at the personal level or at the corporate level (but not both), depending on where the income in fact ends up. Such proposals are generally referred to as "integrating" the corporate and personal income taxes. There are also under consideration other options to improve the taxation of capital, which are described briefly later in this memorandum.

The Joint Committee staff under Dr. Woodworth is presently supportive of integration proposals. The Treasury and Joint Committee staff have in preparation a rather extensive "white paper" on the subject. It is targeted for completion by the end of the summer, to be available when the Committee is ready for mark-up in the fall.

The Joint Committee staff's role vis-a-vis the Ways and Means Committee is such that the staff refrains from advancing proposals on its own, and the paper will therefore concentrate on analysis. However, we anticipate that the analysis will be sympathetic and that the report can suggest a preferred form or forms of integration system. The project represents a unique opportunity to develop a good proposal as a joint effort and to help keep the subject of capital and capital formation from degenerating into a Democrat vs. Republican issue, which is a major danger.

Recommendations:

We should ask to appear not as the lead-off witness on June 23, but to appear instead immediately after the July 4 recess.

Our testimony on July 7 would re-endorse those provisions of last year's bill which were based on the Administration proposals plus some of the other provisions (as described later in this paper). It would describe and stress the capital problem, outlining possible approaches; refer to Joint Staff analysis of the integration issue; and indicate our desire to work with the Committee and to testify again on the subject after the hearings and before the Committee commences mark-up in early fall.

The proposals of the Labor Management Committee with respect to utilities would be discussed in the testimony as a separate subject and we would ask the Committee to consider it first and as a separate package. That approach is similar to that adopted in January when our presentation covered both the rebate and the energy provisions, but asked that the Committee consider the rebates first--which it did.

II. REPROPOSAL OF 1973 TAX REFORM PACKAGE

A. Items Recommended for Reproposal

Items Originally Proposed by the Administration

. MTI (Minimum Taxable Income)--A minimum tax designed to insure that all taxpayers pay a reasonable tax on their economic income and not be permitted to wipe out their taxable income by pyramiding exclusions and personal deductions. Note: Under MTI no individual deduction or credit is reduced, but taxpayers could not use personal deductions and other exemptions in combination to offset more than one-half their economic income. We proposed to include charitable deductions in this limitation, for if it is not included there are a number of situations in which high income taxpayers will still pay little or no tax. Ultimately, the Committee bill took charitable deductions completely outside the proposal. On balance, we believe it desirable to endorse this provision in the form in which the Committee adopted it, which means that charities will be totally unaffected, but that also means that there will continue to be a significant number of high income persons who pay no tax.

. <u>LAL (Limitation on Artificial Accounting Losses)</u>--A proposal to prevent tax shelters, which result where profitable enterprises can use tax accounting rules to produce artificial losses which are then used to reduce income from other sources.

. <u>Simplification</u>--A series of hard-to-itemize deductions would be eliminated and replaced with a "simplification deduction" which is easy to compute and on the average somewhat larger than the deductions given up.

. <u>Elimination of Foreign Withholding</u>--The Code imposes a 30% withholding tax on the gross amount of dividends, interest, royalties, rents, and similar items remitted to foreigners with respect to investments in the United States, but permits reduction or elimination of such taxes by treaty. Treaties making various reductions in withholding taxes are in effect with 20 odd countries. We propose that these withholding taxes be eliminated entirely on the ground that they produce little revenue, are largely circumvented, and are a serious impediment to free capital movements among countries. (This Administration proposal was not part of the original April 1973 package, but was advanced later.)

<u>Items Not Proposed by the Administration</u>

Last year's Ways and Means' bill also included a series of items not contained in the Administration's proposals. Most of them reflected solutions to a variety of lesser problems worked out jointly by the staffs of the Treasury and the Committee, some of which had been identified as problems in the Treasury's initial presentation. They included such items as revisions in the provisions relating to retirement income, sick pay, tax-exempt allowances for U.S. citizens working abroad, and deduction of expenses for vacation homes. Some, but not all, of these would be specifically re-endorsed.

<u>Capital gains</u>. The most significant of these other items were a series of provisions relating to capital gains. They included an increase from six months to one year in the holding period, and a so-called "sliding scale" under which a progressively smaller portion of gain would be taxable for assets held for long periods. We endorsed, but did not propose these changes.

Recommendation:

That we specifically endorse the capital gains provisions, which constitute a net liberalization of the capital gains tax.

New Proposals Recommended

Tax Exempt Bonds for Pollution Control and Industrial Development Purposes--The Code permits private parties to issue tax-exempt bonds for purposes of financing pollution control facilities and so-called industrial development bonds. In effect, it extends the tax-exempt privilege to private persons. It has the bad effect of increasing the supply of tax-exempt bonds, driving up interest costs for state and local governments, and losing revenue for the government. Further, as a subsidy it is very inefficient.

In the late 1960's, industrial development bonds appeared to be getting out of hand and in 1968 Congress limited them, although not so tightly as the Treasury would have liked. Special provisions to facilitate tax-exempt financing for pollution control were enacted in 1968.

Once again these private tax-exempt issues appear to be getting out of hand. There has been an enormous growth in their issuance in the last three years, to the point where they occupy a very significant part of the total tax-exempt market and exert major upward pressure on interest rates for tax exempts issued for conventional purposes.

Unfortunately, these provisions are a gimmick which Congress loves and it seems to view them (erroneously) as a device for conferring benefits on voters at no cost to the government. The fact that pollution and jobs are both motherhood topics makes this temptation even greater.

States and municipalities are concerned about the growth of these issues, as is a significant segment of the securities industry.

Recommendation:

The July 8 presentation should "view with alarm" this situation and propose cutting back the existing limitations. Even if Congress does not accept the cutbacks, such a proposal will help fend off the attempts to further liberalize the provisions, which we know will be coming.

Items on Which There Is Agreement Not to Repropose

. Foreign Provisions--We previously proposed to subject to tax in the United States the earnings of foreign subsidiaries where the subsidiary was used to take advantage of foreign tax holidays and other major foreign tax incentives. These proposals were intended as a counteroffensive to the Burke-Hartke proposals to end deferral entirely, and were designed to highlight the fact that tax deferral is a legitimate issue in only a handful of cases. Subsequently, in the 1975 Tax Reduction Act, Congress tightened up on foreign taxation. At present, we believe that enough has been done and that we should not affirmatively readvance these proposals, but should save them as a fall-back in the event a movement for a more drastic Burke-Hartke type proposal gains momentum.

. Property Tax Relief for the Elderly and Tuition Credits for Private Schools--These proposals were substantial revenue losers, added to the tax reform package at the request of the White House. A subsequent Supreme Court decision made the tuition credit proposal illegal. The property tax proposal gathered no support from anyone and the Committee declined to take it up.

. Taxable Municipals--Local governments could elect to issue taxable bonds on which the Treasury would pay a subsidy equal to 30% of the coupon. The proposal would expand the market for local government obligations and the subsidy would be largely offset by the fact that there would be fewer tax-exempts in the hands of taxpayers. The Committee declined to take up this proposal last year, principally in the belief that it was politically treacherous. Some members of the Economic Policy Board are concerned that such a proposal would open the door to still greater subsidies for state and local governments, including federal guarantees of their obligations. On balance, we recommend that this item not be reproposed.

B. Revenues

The reproposals above indicated increase revenues perhaps $200 to $300 million. The MTI and LAL proposals gain revenue, but the simplification proposal loses revenue because the new simplification deduction was intended to buy out a series of other deductions and was, therefore, on average larger than the deductions eliminated. The capital gains proposals also lose revenue, but not much in the first several years.

III. BUDGET DECISIONS

The Tax Reduction Act included provisions which technically apply only to this year, but are of a semi-permanent nature such that they will undoubtedly be reenacted later in the year. The annual revenue loss from such provisions is approximately $12.5 billion. The reenactment will probably occur late this year and may or may not be a part of the tax reform package.

Issues:

(1) Do we need to raise additional revenues to offset part or all of the $12.5 billion of revenue lost by the Tax Reduction Act?

(2) Can we propose additional tax reform proposals which will throw the tax reform package into a net revenue loss? Any major capital formation proposal will do this, and we therefore need to know the boundaries of permissible revenue loss before we can design the capital formation proposals to be recommended in the fall. It is clear that we should propose nothing that would increase the deficit for FY 1976. However, almost any of the capital formation options can be designed to take effect in FY 1977.

(3) Do we need to propose additional revenue gainers? If we wish to make capital formation proposals and do not wish to have a package with a net revenue loss, then the package must include some revenue gainers. Even if we are willing to have a package with a net revenue loss, the inclusion of revenue gainers may make it possible to lose more on items affecting capital formation. Thus, the questions to be answered are:

(a) Do we need revenue gainers for budgetary reasons?

(b) What revenue gainers may be desirable on their own as a trade-off for other issues?

(4) How do we propose to fund the proposals for utilities recommended by the Labor Management Committee and endorsed by the Administration? The revenue loss for FY 1976 will be from $600 million to $1.5 billion, depending upon whether the increase in the investment credit is made refundable. The revenue loss will increase in future years.

Recommendations:

(1) That we take the position that the 1975 tax reductions, which are temporary in nature, should not be reenacted. It may not be necessary to take this position explicitly on July 8. If we accept the cuts as permanent, we will have accepted correspondingly larger projected deficits for both FY 1976 and FY 1977.

(2) That we proceed to design a capital formation package which would be phased in over a period of years, so that the revenue loss in the first year will be held to, say, $2 to $3 billion. In this connection we should keep in mind that the utilities proposals, although they apply to just a fraction of industry, would lose $1 to $2 billion annually in the next several years. The net budget impact will depend upon whether other revenue gainers are added to the package.

(3) The utility proposals should be presented as part of the total energy package, with the revenue loss to be made up from revenues from energy revenues. Viewed in that way the utilities proposals are revenue-neutral--assuming that Congress does not spend the revenues in some other way.

IV. POTENTIAL REVENUE GAINERS

1. DISC.

DISC is a device, enacted in 1969, to give a tax benefit to exporters. At that time, the dollar was overvalued and we were striving to maintain it at overvalued levels. The principal justification for DISC was that it was difficult for exporters to compete when the dollar was overvalued and that we needed to encourage exports in order to maintain the exchange ratio. Repeal of DISC would gain about $1.5 billion in revenues in FY 1976.

There will be great pressure on the Committee to repeal DISC in the forthcoming bill because Mr. Ullman feels the Committee is under an obligation to produce a bill which will raise at least $1 billion of revenue. DISC is the only "reform" item in sight which would produce revenues of that magnitude. The pressure is further compounded by the fact that a draft inter-agency report recommending elimination of DISC was recently leaked.

The arguments with respect to repealing DISC are as follows:

Pros

- The economic justification for DISC has disappeared with floating exchange rates. The dollar is no longer overvalued and there is no longer a need to maintain an overvalued fixed rate.
- The revenue gains from repeal are substantial and can be put to better use.
- There is no good evidence that DISC has made a substantial contribution to increased exports. Most of the benefits go to companies that have been big exporters anyway.
- The elimination of DISC is a major tax reform objective and is likely to occur no matter what we do. DISC is now difficult to defend on theoretical grounds, and the attempt to do so gives us a pro-big business image, causing us to lose creditability in other areas.

Cons

- Anything that reduces corporate earnings at this particular time is unfortunate.
- Under existing accounting rules, the elimination of DISC would cause a one time decrease in reported earnings in the year of enactment in an amount equal to the tax deferred over several years. This would be seriously inconvenient for some companies.
- If we propose to eliminate DISC, we may get nothing in return for it; it may tactically be better to let it be bargained away in the legislative process.

Recommendation:

That we stand firm in supporting retention of DISC, at least at this time.

2. Alcohol and Tobacco Taxes

These taxes are based on a cents per quantity basis and have not changed for over two decades. Since the prices of the commodities have increased in the interim, the effective rate of tax has been significantly cut. If we were to double these taxes, we would raise approximately $6.5 billion. (The recent U.K. budget proposals included similar tax increases in this area, referred to in the British press as "booze and 'baccy taxes.")

The arguments with respect to increasing these taxes are:

<u>Pros</u>

- Large revenues are available.
- A substantial segment of the public would agree that consumption of these items should be heavily taxed.
- The present tax rates are "out of date."
- Increases here would help shift from heavy reliance on income taxes to greater reliance on consumption taxes.

<u>Cons</u>

- Excise taxes that distort consumer choices are generally not a good idea, unless they are justified as a user charge or as effectively implementing a strong public policy.
- The tax increase would be highly regressive in most cases.
- The present level of tax is substantial (<u>e.g.</u>, 8¢ on a pack of cigaretts and $1.85 on a fifth of whiskey).
- A major, abrupt increase would be disruptive to three major industries.
- States have heavy taxes on these items and would resent further federal pre-emption of this tax base.
- Increases in these items will affect the Consumer Price Index, which will in turn significantly increase the cost of governmental programs, thus offsetting a part of any revenue gain.

Options

Option A: Propose a significant increase in these taxes-- perhaps 50%-- and at the same time propose that they be recast as ad valorem taxes (i.e., percentages of value), so that they will increase automatically in the future and not get "out of date" as the present taxes have.

Option B: Propose no increase or only a slight increase in the present level of these taxes but propose that they be recast as ad valorem taxes, so that they will help offset future deficits.

Decision

Option A ________

Option B __RCJ__

V. CAPITAL FORMATION MEASURES

The Administration does not yet have a carefully worked out analysis of, or position on, the extent or nature of the so-called capital or capital formation problem. There is general agreement that there are several structural problems with respect to capital--such as the dangerously high debt-equity ratios, the inability of utilities and other regulated industries to attract capital and the recent low level of corporate profits. It is less clear that the level of aggregate capital formation is seriously insufficient.

In general, there are many other aspects to the problems of capital than taxes, and undue concentration on tax benefits as a panacea for business problems is unwise, especially if it serves to obscure the real problems.

Nonetheless, taxes play a very major role with respect to capital. The existing two-tier system of corporate taxation, for example, is a major contributor to the problem of high debt-equity ratios. In general, it is the consensus that some lessening of the impact of taxes on capital would be desirable.

Tax measures that might have a major impact on the problems of capital would entail major revenue losses. In focusing on the problem of capital formation--as distinguished from structural problems--it is important also to keep in mind that a given reduction in business taxes will not increase capital by a like amount. If business taxes were cut, say $10 billion, businesses which get the reductions would, in the short run, have an additional $10 billion; but the tax reductions would divert capital from other industries and affect prices, and in the longer run, the net increase in total capital in the system might be only $2 or $3 billion--or perhaps, even zero. This effect is not commonly understood by either businessmen or Congressmen, almost all of whom equate any business tax reduction with a net increase in total capital.

There are a number of options which would lessen the tax burden on capital and that, as a consequence, would increase the rate of capital formation--subject to the limitations discussed above--and, consequently, the levels of employment and prosperity. Some of those options would also make our existing stock of capital work more efficiently (and others would induce inefficiencies). From the point of view of overall productivity, if existing capital does more, that is as useful as obtaining an equivalent amount of new capital; and from the point of view of the total economy it is preferable, as it achieves increased productivity without decreasing consumption.

The principal options to benefit capital include:

(1) Integration of corporate and personal income taxes, i.e., reduction or elimination of the double tax burden on capital in corporate form.

(2) More liberal cost recovery rules. This includes provisions to permit depreciation deductions to be adjusted for inflation, to allow faster write-offs of capital investments and to liberalize or to make permanent the recent liberalization of the investment credit.

(3) Liberalize the taxation of capital gains.

(4) Place a maximum 50% tax rate on all income (such a maximum now applies only to "earned" income and not to investment income).

(5) Tax exemption for dividends which are reinvested in the paying corporation, particularly in the case of utilities.

(6) Liberalize the deductions presently available to individuals for contributions to individual retirement accounts (IRA's). Under the 1974 pension legislation, individuals can set up special accounts with banks, insurance companies, mutual funds, etc., and deduct amounts invested in those accounts for retirement. The provision was designed to deal with persons who were not covered by a pension plan, and the limitations on who may contribute and how much they may deduct are rather tight.

One cannot put a price tag on the above items because each can be tailored to produce widely varying losses to the government and gains to the owners of capital. In general, the revenue losses are a rough indication of the benefit conferred. However, major benefit increases in some of the items--the investment credit, for example--would introduce some degree of efficiency loss. The more effective a proposal would be, the greater would be its revenue loss.

Recommendation:

That on July 8 we explain the seriousness of the capital problem, outline the options for dealing with it, and indicate our desire to work with the Committee and its staffs and to deal with more specific proposals at the end of the hearing process.

Depreciation: A Special Problem

At present, business generally uses lower depreciation for financial purposes than for tax purposes. In the opinion of many, financial depreciation seriously understates actual depreciation and thus seriously overstates financial earnings. To the extent that is true, it leads to bad internal management decisions with respect to investment, prices and dividends, to the public feeling that corporations are not in trouble, to increased wage demands, and, finally, to the understandable Congressional reaction that tax depreciation is excessive even now.

The failure of business to use tax depreciation for financial purposes is attributable to some extent to antiquated accounting standards and inadequate understanding of economic depreciation, to some extent to the desire of business management to give itself the best possible report card in terms of earnings per share, and to a large extent to the fact that single companies are fearful of using a method which tends to lower their earnings if their competitors do not do so.

It has been suggested that the problem be attacked by providing that while taxpayers may continue to use all existing methods of liberal tax depreciation, the aggregate amount deducted for tax purposes could not exceed the amount it was willing to report for financial purposes. Such a proposal would:

- Put great pressure on companies to use better financial depreciation.

- Go to the heart of a significant aspect of the capital formation problem by improving the basic economics of business decision-making and public understanding.

- Assist greatly in holding the line on present liberal tax depreciation rules.
- Add substantial credibility to our overall proposals benefiting business, by indicating our willingness to be tough as well as generous.
- Be applauded by some business leaders and denounced by others.

Option

That we advert to this problem in our July presentation by stating that Congress may wish to continue something along these lines, without actually endorsing such a proposal. This would get the idea out for discussion and give the business community an opportunity to focus on the problem over the summer and before the Committee begins markup in the fall.

Agree WEF

Disagree ________

October Proposals

Our October proposals included a restructuring of the investment credit and a deduction for dividends on special classes of preferred stock. Our position on these proposals is that they are being reconsidered in the light of the total capital formation picture and will be addressed in that context before the Committee begins markup.

William E. Simon