THE WHITE HOUSE

WASHINGTON

July 24, 1975

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR: L. WILLIAM SEIDMAN

FROM: JAMES E. CONNOR JEC

SUBJECT: ECONOMIC AND ENERGY MEETING ON CAPITAL FORMATION

The President has reviewed your memorandum of July 23rd on the above subject and approved the following decisions:

1. No meeting necessary.

2. Secretary Simon should proceed with testimony on July 31.

3. If testimony is given on July 31, should include integration of corporate and individual incomes or corporate earnings and broader ownership of capital.

Please follow-up with appropriate action.

cc: Don Rumsfeld

THE WHITE HOUSE

WASHINGTON

July 23, 1975

MEMORANDUM FOR THE PRESIDENT

FROM: L. WILLIAM SEIDMAN LWS

SUBJECT: ECONOMIC AND ENERGY MEETING ON CAPITAL FORMATION

After our meeting with you on Tuesday, July 22, the Executive Committee of the Economic Policy Board has continued its discussion of capital formation and, in particular, proposals for corporate integration and for broadening capital ownership.

None of the members of the Executive Committee has any additional information for you on the question of whether or not Secretary Simon should testify on July 31. The votes of the agencies with respect to testifying are as follows:

Treasury................	Yes
Commerce................	Yes
Federal Reserve Board...	Yes
Labor...................	No
CEA.....................	No
State...................	Abstain
OMB.....................	Very strongly favors delay because of likely opposition to the package from farmers, small businesses, labor, and consumer groups.

If you decide that he should proceed with testimony the views of the members of the Executive Committee on the question of adopting the Treasury proposal for corporate integration of income taxes and broaden capital ownership are as follows:

Treasury................	Yes
Federal Reserve Board...	Yes
CEA.....................	Yes, but these proposals are not a full solution to the capital formation problem.
Labor...................	Yes, with reluctance

OMB...................... Yes, with reluctance
Commerce................ Yes, but the details of the testimony are very important and some sort of job creation plowback should be added.

A summary of the corporate integration proposal and proposals for broader equity ownership with pros and cons from the memorandum Secretary Simon sent to you earlier this week is attached at Tab A.

In light of these recommendations the Executive Committee does not feel that an additional meeting is necessary in view of your tight schedule. They believe you have all of their arguments and would simply await a decision. However, they are prepared to meet with you if you desire.

Decision

1. No meeting necessary.

   Agree MRF ________ Disagree ________

2. Secretary Simon should proceed with testimony on July 31

   Agree MRF ________ Disagree ________

3. If testimony is given on July 31, should include integration of corporate and individual incomes or corporate earnings and broader ownership of capital.

   Agree MRF ________ Disagree ________

Comment:

Tab A

1. Integration of Corporate and Personal Income Taxes.

Of the various options, Treasury greatly prefers a proposal which would begin to eliminate the double tax on corporate income, i.e., to "integrate" the personal and corporate income taxes. At present, the income from assets held in corporate form is taxed once at the corporate level and again at the shareholder level. "Integrating" the corporate tax would cause income to be taxed at one level or the other, depending on where it came to rest, but not at both levels.

The merits of integration are not to be confused with the issue of whether it is stockholders or consumers who ultimately bear the corporate tax. The fact is that the double level tax must be paid by someone. Whether it comes out of profits or causes prices to increase, the result is that it inhibits investment in corporate form and causes the total private stock to be less productive than it would otherwise be. An investor must either obtain higher prices or he must settle for lower profits than would otherwise be the case.

Pros.

A system of corporate integration is the single most important change we could make in the income taxation of capital because:

- It affects the great preponderance of the capital in the United States, which is in corporate form. It is the broadest most neutralizing kind of change possible. It does the most to maintain a free market and price system.

- It has these political attributes:

  -- It is an understandable principle. Most people should agree with the proposition that income should not be taxed twice.

  -- It is a relatively new idea in the political arena, which means that there are a minimum of people committed to positions of opposition.

  -- The fact that so many other countries have recently gone to such a system will be persuasive to many.

-- Most economists with informed views on the subject agree that integration is "correct" in principle, even though many of them would not support it if the total package is regressive.

-- It is not just an "incentive bonus" for business as increased depreciation and the investment credit are generally thought to be. Eliminating double taxation is removing a <u>dis</u>incentive--correcting an inequity.

-- It can and should be presented as a package. Business should give up something, too, in that package, and that should help to make it politically salable and budgetwise manageable.

-- Integration is <u>not</u> shareholder relief. This will be hard to get across and the demogogues will choose to ignore it. However, it is correct. Most economists believe that a substantial part--perhaps as much as half--of the burden of the corporate tax rests on consumers. To that extent it is a regressive tax. Its removal will benefit the general public in a progressive fashion and the cost of removal is appropriately charged in part against general revenues. The remainder of the burden of the corporate tax falls not on shareholders, but is economically shifted to <u>all</u> who save. In the long-run, for example, the small depositor in an S&L benefits as much as a shareholder.*

*The reason why this is so, is sometimes referred to as the "Harberger effect," after the economist who first described and documented the phenomenon that the burden of the corporate tax, to the extent that it does not fall on consumers, is distributed across investors generally and not just stockholders. The effect is generally accepted by economists and may be summarized as follows: If the corporate tax simply reduced returns for stockholders, no one would invest in stocks. Everyone would invest in bonds or noncorporate assets. If a corporate tax were imposed for the first time that is what would happen at the outset, but as more persons tried to invest in noncorporate assets, the price of such assets would go up and their return would go down. Similarly, as fewer persons wished to invest in stocks, the price of stocks would go down and their return to investors would go up. This process would continue until the after-tax returns to investors equalized in the corporate and noncorporate sectors. The net result is that the economic burden of the tax is distributed also among other non-stock investors in the form of lesser returns. If the corporate tax is eliminated or reduced, the same thing happens in reverse.

- Corporate integration would eliminate the existing discrimination in favor of debt as compared with equity financing, and strike at the heart of the debt-equity problem.

- It greatly improves the efficiency of capital allocation. It would remove the discrimination in favor of investment in noncorporate form. It would also eliminate the misallocation which arises because of the present tension between ordinary income and capital gain.

- It will make the capital markets more competitive. Corporate managers will have to justify the retention of earnings and demonstrate to their stockholders that they can do a better job of investing profits than the shareholders could do for themselves. At present, there is a great tax penalty on paying out earnings, and the result is that corporate managers are under great pressure to do almost anything productive with retained earnings rather than pay them out. Integration would, in effect, "unlock" corporate capital.

- The proposal would be a one-time, dramatic shot in the arm for the stock market. On enactment, equity investments will immediately be worth more.

- Corporate integration would be an enormous help to utilities and to other industries whose investors rely upon steady dividends.

- Most of our major foreign competitors have recently gone to such a system, namely, the United Kingdom, Canada, France, Germany, and Japan. The EEC has adopted a policy favoring integration for member countries. Sooner or later, the lower tax costs will be reflected in the prices of foreign goods, and U.S. manufactured goods will be at a competitive disadvantage. Further, increased yields abroad will give foreign based competitors an edge in attracting equity capital.

Cons.

- The proposal lends itself to demogogery about relief to shareholders (which as a class are highly concentrated in the top income classes).

- The idea is politically new and popular thinking may not be properly conditioned. Even some corporate managers--who ought to favor it overwhelmingly--will oppose it because they like to retain earnings and the present system imposes a penalty on doing anything else.

- The existing penalty on corporate distributions encourages retention of corporate profits, and all of those retentions show up in the statistics on total savings (even though they may be partially dissipated in waste and inefficiency). To the extent that integration encourages distributions, some portion of those additional distributions may be consumed. Focusing on this single aspect overlooks the facts that integration proposals assume a substantial net tax reduction which will be added to savings unless consumed and which will itself induce additional savings; and that most of the distributions will go to individuals or institutions that are likely to save all or virtually all of those distributions. Nonetheless, some will be concerned that integration means giving up the degree of "forced savings" which is inherent in the tax penalty on distributions.

Outline of Proposal and Cost.

The cost of completely eliminating the second-tier tax on corporations would be in the neighborhood of $15 to $18 billion at current revenue levels, with substantial variation depending upon the details of the proposal.

The general outlines of what Treasury has in mind are as follows:

A substantial part of the integration, perhaps 30 percent to 50 percent, would become effective on January 1, 1977. Business would contribute to that by giving up some other specialized preferences, such as a part of the investment credit (which is scheduled to drop from 10 percent to 7 percent anyway at the end of 1976) accelerated depreciation on real estate, DISC, and by a slight increase in the corporate tax rate. The net revenue loss for the first year would thus be confined to approximately $3 billion. The remainder of the integration would be phased in over the succeeding five years, at an annual additional revenue loss of $1 to $2 billion. (All revenue estimates expressed in 1975 levels.)

2. Liberalization of Depreciation.

Treasury in recent years has placed great emphasis on the need for liberal depreciation rules. Depreciation provisions were substantially liberalized in 1962 and again in 1971. Treasury economists believe them to be reasonably liberal as they now stand. The 1971 liberalizations have been a prime target of tax reformers, and as late as last fall Dr. Woodworth and others were predicting that Congress would cut back the existing allowances.

Following the 1971 legislation, Treasury set up a special office, the Office of Industrial Economics, to study depreciation practices and to see that allowances are maintained on a liberal but defensible basis. Treasury believes that existing allowances are in the range of what can be defended, i.e., that they correspond reasonably to real economic depreciation. It is not possible at present to justify further major increases in tax depreciation as reflecting economic reality, and proposals for further increases would have to be defended simply as "incentive bonuses." It is an uphill job even to defend the depreciation allowances under the 1971 legislation. That job is made substantially more difficult by the fact that businesses generally do not show for financial purposes as much depreciation as they are taking for tax purposes--which liberals understandably use as evidence that present allowances are excessive.

A further liberalization of depreciation allowances is an option to reduce the tax burden on capital.

Pros.

- Depreciation is associated in the public mind with tangible assets, and a proposal to liberalize depreciation may appear more relevant to the ordinary layman than other options.
- Other countries have cost recovery rules which are more liberal than those in the United States.

Cons.

- Liberalizing depreciation cannot be presently justified on the basis of existing economic data.
- Advancing depreciation proposals which can be justified only as "incentive bonuses" infects the public's perception of depreciation generally and seriously jeopardizes our ability to preserve the liberalizations which we have achieved.

- Even if liberalization were temporarily achieved, it would very likely be turned off again in the reasonably near future, as the investment credit has been. An off-on depreciation system would be <u>very</u> undesirable and destabilizing.

- In view of the positions taken on existing depreciation, the odds are that we would be unsuccessful in any proposals for further liberalization.

- The argument that laymen would perceive depreciation as more relevant to the capital problem loses much of its force when it is recognized that the vast majority of laymen have not the foggiest notion of what depreciation is. The argument that other countries have more liberal rules may to some extent be politically persuasive, but is analytically oversimplistic. One needs to look at total tax systems, rather than just depreciation provisions in order to make valid comparisons about burdens on capital.

3. Capital Gains.

Further liberalization of taxes on capital gains is a popular proposal in many conservative quarters. It would help in capital formation, but it is not so important as fundamental changes like integration. It has relatively little effect on business operating profits, but is important primarily at the individual investor level. The capital gains tax is already in large part avoidable (by simply choosing not to sell) and a decrease in a tax which is largely avoidable anyway cannot be expected to produce much incentive.

The Ways and Means Bill last year would have made limited changes in the capital gains rules which represented a net liberalization. The principal feature was a new exclusion (in addition to the present 50 percent) ranging from 1 percent to 20 percent for assets held from five to 25 years or more, thus, making the maximum exclusion on a single asset 70 percent. The Administration endorsed those proposals last year and reiterated its support of them in Secretary Simon's testimony before the Committee earlier this month.

The arguments for liberalizing the taxation of capital gains are as follows:

Pros.

- Capital gains are perceived by many (erroneously) to be the principal point at which the tax system impacts on capital and capital formation. Liberalization would have immediate popular appeal to those primarily concerned with capital formation.

- Lower capital gain taxes would decrease somewhat the cost of capital and help in greater capital formation. "Unlocking" produced by lower rates on long-held assets would increase investment activity (as distinguished from increasing the amount of capital) and could have a stimulative ripple effect.

- Lower rates would tend (depending on the form of the proposal) to compensate for the fact that much of the gain on long-held assets is apt to be illusory because of inflation.

- No major revenue loss in first year, as revenues from larger number of sales due to unlocking would offset decrease in rates.

Cons.

- The existing capital gains preference is widely viewed (erroneously) as the biggest of all tax loopholes. Further liberalizations will meet strenuous opposition in this Congress, and it will be difficult to secure even the limited liberalization adopted by the committee last year.
- The existing spread between capital gains rates and ordinary income rates causes (1) much of the complexity in the present tax law and (2) considerable misallocation of capital. Increasing the spread will increase those problems.
- The fact that 50 percent of capital gain is excluded from tax is a rough but satisfactory allowance for the fact that much gain is illusory because of inflation.
- Capital gains is not the most important area to improve capital taxation and we should concentrate our limited ammunition elsewhere.
- After the first year the annual revenue loss would rise to perhaps $800 million.

4. Investment Credit.

The 1975 Tax Reduction Act increased the investment credit to 10 percent from 7 percent generally and from 4 percent in the case of utilities. Assets with lives from three to seven years get only a partial credit, and assets with lives of less than three years get none at all. The present 10 percent level is temporary, however, and, unless there is further legislation, will revert to 7 percent generally and 4 percent for utilities in 1977.

The credit has been a useful device and is a back-door method of reducing the cost of capital in a manner which has been politically acceptable to a number of persons who have opposed more direct and neutral methods, such as lowering corporate rates. However, it possesses a number of characteristics which make it seriously discriminatory as between companies and different kinds of capital investment. As the credit grows larger, the distortions which it creates become a matter of more serious concern.

In our October proposals, we requested that the credit be raised to 10 percent, but at the same time we proposed that it be restructured in a manner which would reduce its more discriminatory features. A number of business leaders objected to the restructuring.

An option is to increase the credit still further. Each percentage point by which the credit is increased causes a revenue loss of approximately $800 million, assuming no restructuring.

Pros.

- The investment credit has so far been the most politically acceptable way of reducing taxes on capital. It may for that reason be more easily accomplished than other alternatives.

- The credit is especially useful at times when the economy needs special stimulus. Conversely, it is more apt to overstimulate at a time when stimulus is not needed.

Cons.

- The credit is seriously discriminatory against many companies and activities and should not be significantly increased without restructuring.

- The higher the credit is, the more tempting it becomes to turn it on and off over the business cycle.

- Unlike other capital reform options, the credit is justified simply as an incentive, is widely perceived as such, and is hard to justify on any other basis.

- Major increases in the credit will not help many of the companies that most need help, i.e., growing companies, companies in financial difficulty, and small businesses.

- The investment credit is an old issue and lacks "sex appeal." Congress has only recently raised it, and is likely to feel that is has dealt satisfactorily with it. There is likely to be little interest in doing more, particularly if recovery appears assured by the time the subject comes up for decision.

5. Corporate Rate Reductions.

The present corporate rate is 48 percent. Each 1 percent decrease in the rate loses about $1 billion of revenue.

Pros.

- Corporate rate reductions are sound, neutral, and effective as a means to provide more capital.
- As a mechanism, rate reduction has the advantage of great simplicity, and changes can be made quickly and flexibly within the framework of existing law.

Cons.

- It is politically unappealing. Many are on record as opposing such reductions.
- A significant reduction of corporate rates raises tax equity problems. Many now complain that it is inequitable to permit individual taxpayers in the 70 percent brackets to accumulate income in corporate form at a 48 percent rate. To the extent that is perceived as an inequity, a decrease in the corporate rate will make it worse.

6. Incentives for Private Savings and Broadening Capital Ownership.

A. Retirement Accounts.

Pension and profit-sharing plans have become a major source of savings in our economy. The tax laws provide major benefits for participants in such plans, as employer contributions are deductible by the employer and not taxed to employees at the time paid into the plan, and earnings on plan assets are also exempt from tax. However, about half of our population is not covered by such plans. The 1974 pension legislation for the first time permitted individuals who are not adequately covered by existing plans to set up their own "individual retirement accounts" (IRA's) with essentially the same tax benefits enjoyed by other pension and profit-sharing plans. There are, however, significant statutory limitations on who may use such plans and how much they may put into it. Liberalization of those limitations--permitting a greater number of persons to put greater amounts into such plans--is an option to encourage more savings by individuals.

Pros.

- Will be perceived as an option directly benefitting individual taxpayers in the medium-income classes, as distinguished from "business" generally.

- Would help even up existing discrimination between those who have generous plans with attendant tax benefits and those who have inadequate plans or no plans at all.

Cons.

- There was substantial opposition last year even to the benefits now provided. That opposition seemed to spring largely from the belief that these provisions would generally benefit high-income persons.

- There is a substantial degree of inefficiency in such a proposal--little additional saving for capital formation per dollar at revenue loss--for much of the tax benefits would accrue in respect of amounts which individuals would save in any event. (To some extent this could be minimized by varying the mechanisms, as, for example, by providing a deduction only for amounts in excess of, say, 50 percent of income.)

- The encouragement of individual savings is quantitatively much less important than the encouragement of business savings.

B. <u>Stock Acquisition Incentives.</u>

Another alternative--which might, or might not, be combined with liberalization of retirement account provisions--is to provide new incentives for stock ownership by employees and other middle income persons. One such plan, known as the "Kelso plan" (named for the promoter who devised it) has been vigorously advocated by Senator Long. It enjoys tax advantages under present law, and Mr. Kelso proposes still further tax benefit legislation (which Senator Long has not, so far, expoused). Other employer sponsored profit-sharing and stock purchase plans also enjoy tax benefits under present law.

A difficulty with employer sponsored plans is that the employer-paid benefits tend to be in lieu of additional wages, and many employees and most unions seem to prefer additional wages. Senator Long appears to be embarked on a campaign to coerce employers into such plans by making them a condition of other, unrelated benefits. That seems unwise as a restriction on desirable market forces and also unfair as to employees who don't get such benefits. To date, organized labor has opposed such plans.

Stock ownership is presently highly concentrated into hands of very high income persons and it would be desirable to expand ownership. The figures are deceiving, however, as lower income persons have large indirect stock interests through mutual funds, pension plans and insurance policies.

We are working to see whether we can devise new incentives which will (i) increase direct stock ownership by middle income person, (ii) increase total private savings, <u>without</u> (iii) undue complexity, and <u>with</u> (iv) a revenue loss which is not incommensurate with the benefits achieved. The drawbacks are, in general, similar to those described in the case of liberalized retirement account provisions.