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ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEETING

AGENDA
8:30 a.m.
Roosevelt Room

May 18, 1976

- | | |
|--|----------------|
| 1. Administration Job Creation Initiatives | Gorog/Treasury |
| 2. Options for Assistance to the Maritime Industry | Commerce |
| 3. Update on the Rubber Industry | Labor |



FYI

THE WHITE HOUSE
WASHINGTON

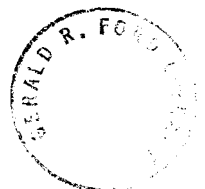
May 17, 1976

MEMORANDUM FOR ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE

SUBJECT: Tuesday, May 17 EPB Executive Committee meeting

The "Options for Assistance to the Maritime Industry" paper prepared by the Department of Commerce was distributed to EPB Executive Committee members the week of April 26.

A paper on the "Update on the Rubber Industry" being prepared by the Department of Labor will be distributed later today.



THE WHITE HOUSE

WASHINGTON

May 17, 1976

MEMORANDUM FOR ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE

The attached paper prepared by the Department of the Treasury on "Administration Job Creation Initiatives" will be discussed at the Tuesday, May 18, 1976 EPB Executive Committee meeting.

Attachment



cc David Lissy



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

MAY 14 1976

Memorandum For: Economic Policy Board Executive
Committee

From: Charles M. Walker *CW*
Assistant Secretary

Subject: Administration Job Creation Initiatives

This memorandum comments on William Gorog's proposal, in his April 30, 1976, memorandum for "a new legislative initiative to focus public attention on the President's proposals for job creation and economic growth." The new legislative initiative would have two major aspects: (1) a repackaging of existing Administration proposals for individual tax relief, tax incentives for savings and job creating investment, small business and farm estate tax relief, and countercyclical public works and (2) the addition to these proposals of more generous capital recovery provisions and other business tax breaks.

I will comment first on the likely general desirability of new legislative initiatives at this time and will then turn to the more technical tax policy merits of the new proposals.

I. The Desirability of New Legislative Initiatives

It is asserted that House Republicans feel the need for a publicly visible program emphasizing job creation in the private sector to counter the much discussed Humphrey-Hawkins bill. This is certainly understandable. I question though whether a repackaging of existing Administration proposals in the form of a new legislative initiative is preferable to other ways of drawing attention to the Administration's good record.



The Administration has repeatedly presented an integrated program of tax legislative initiatives, together with an associated policy of expenditure restraint, designed to assure a steady return to full employment and, equally important, long-term prosperity. The Administration has a solid record in this respect, and has presented a program which makes sense.

The elements of the presently outstanding legislative proposals which would be incorporated into the proposed "Job Creation and Economic Growth Act of 1976" have been vigorously promoted by the President, especially in his October 6, 1975, presentation of his proposed program of tax cuts and Federal spending restraint, and in the January 19, 1976, State of the Union message. In the fact sheet distributed to the press in connection with the State of the Union message, all of the elements of the proposed Job Creation and Economic Growth Act of 1976, with the exception of the integration of corporate and individual income taxes and a possible counter-proposal to the vetoed public works and public service employment bill, were presented as an integrated program under the general heading of "Economic Program and Prospects," with subheadings, "Sustained Economic Growth without Inflation," and "Job Creation and Employment." Secretary Simon has also on several occasions presented comprehensive statements of the Administration's tax proposals, most recently in his testimony on March 17 (with followup on April 13) before the Senate Finance Committee.

Thus, it is my view that we should take every opportunity to support our current legislative program, and to emphasize its job creating effects. However, a new legislative initiative at this time is likely to be taken as mere window dressing.

Furthermore, the Administration has outstanding a number of legislative initiatives. Whatever the merits may be of the new proposals suggested for consideration, there is a risk that we would not be taken seriously in introducing them at this point, when there is so much unfinished business. The Administration has been criticized for its reactive posture in the course of the current primary campaigns, and this might be seen as another example.



II. Tax Policy Aspects of Proposed New Options

Let me turn now to some discussion of the additional options suggested for possible inclusion in an Administration--sponsored Jobs Creation bill. These are:

1. Updating and liberalization of the table of useful lives for depreciating plant and equipment, along lines incorporated in Kemp's Job Creation bill.
2. Simplification and liberalization of write-off for pollution control facilities mandated by law.
3. Authorizing the use of replacement cost evaluation of assets for calculating depreciation deductions.
4. Phased increase of the corporate surtax exemption from \$50,000 to \$75,000 in 1978 and to \$100,000 in 1979.
5. Minor modification of securities regulations and tax laws to encourage venture capital for small, high technology enterprises.

Revenue effects of adopting these proposals are attached (Tab A).

The first three items in the list would in one way or another accelerate or increase depreciation allowances for tax purposes. Regardless of the merits of these particular proposals we should be mindful of a certain risk in raising this set of issues at all. The matter was succinctly put in a Treasury memorandum to the President on tax reform outlook and options last June:

"Proposals to liberalize depreciation have the political advantage of being easy for people to understand--they are associated with things that are new and tangible, such as machines and buildings. However, the depreciation provisions were substantially liberalized in 1971, and are believed by Treasury economists to be reasonably liberal as they now stand (which should be the goal). The existing liberalizations have been a prime target of tax reformers since 1971. As recently as last fall, Dr. Woodworth and others were predicting that Congress would cut back the existing allowances.



"Treasury has in the past placed great emphasis on the need for liberal depreciation rules, and in 1971 set up a special office, the Office of Industrial Economics, to study depreciation practices and to see that the allowances are maintained on a liberal but defensible basis. However, it is not possible at present to justify further major increases in depreciation allowances. It is an uphill job even to defend the present rates, in view of 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.

"The net result of proposing liberalizations in depreciation is almost certain to be reactivation of depreciation as a political yo-yo issue, little likelihood of prevailing even temporarily, and considerable danger that in the fray we will lose the gains we have already consolidated."

An item by item discussion of the proposals follows:

1. Accelerating Depreciation

This item refers to the 40 percent variation from the ADR guideline lives and alternative capital recovery mechanism described in item 8 of the comparison between the President's program and the Kemp bill (See the Comparison Table, Tab C of Gorog memo).

The Revenue Act of 1971 established an Office of Industrial Economics responsible for updating depreciation lives for the ADR system on the basis of actual industry experience. Under this procedure, the Treasury periodically announces changes, up and down, in guideline lives. While Treasury regards the ADR system as a method for accurately measuring income, it is under attack as a loophole.

We have generally supported the present 20 percent variation from guideline lives as a reasonable method of permitting taxpayers to utilize depreciation lives which reflect actual economic lives in their firms. We should resist proposals to increase the range to 40 percent and, thus, to convert ADR into an explicit fiscal policy mechanism for promoting greater investment during a recession. Such proposals would make the ADR system a political football. If it did not fall to reformers we might confront recurrent changes in the ADR range that would create undesirable uncertainty for investment planning.



For the same reasons, namely the integrity of depreciation in the income measurement system, we should oppose the alternative means of capital recovery, patterned from the Capital Recovery Allowance Act (proposed new Section 189 of the Code).

2. Rapid Write-off of Pollution Control Investment

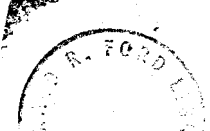
This item refers to the alternative one-year write-off for pollution control facilities described in item 15 of the Comparison. A 1969 Code amendment authorized five-year amortization for such investment, provided the facility was added to a pre-1969 plant and was placed in service before 1976.

Five-year amortization was adopted on the ground that relief should be afforded to businesses unexpectedly saddled with the additional expenses of adjustments to new pollution control standards. We recommended, and Congress agreed, that five-year amortization should be limited to plants which were already in operation by 1969.

Now that there has been a general adjustment to new pollution control standards, investments required to meet those standards should be treated like all other investments. That is, the cost of complying with pollution control standards, like the cost of meeting safety or fair labor standards, is properly regarded as an anticipated part of the cost of doing business. Hence, the consumer should pay for such cost in the price of the product, and regular depreciation rule should apply to pollution control facilities. Certainly there is no justification for the proposed one-year write-off.

3. Use of Replacement Cost for Asset Valuation

This would be a major innovation in our tax system. We have generally argued that it should be considered in conjunction with a full range of adjustments and accounting procedures appropriate to an inflationary environment. However, it is basically a desirable change from a tax policy point of view, and a case could be made for undertaking it. Nevertheless, a number of technical questions would require consideration before a sound proposal could be formulated. It is essential to avoid premature presentation of a proposal without adequate consideration and preparation of the groundwork for discussion with the Congress, businessmen, and opinion makers. Failure to make this preparation might set back for years any realistic prospect for enactment.



I take it that the primary reason for proposing replacement cost accounting is the fact that historical cost depreciation tends to understate economic depreciation in a time of inflation, with the result that taxable income is artificially increased and therefore the effective rate of taxation of earnings from capital are increased. The term "replacement cost depreciation" sometimes refers to a method of accounting which systematically incorporates changes in asset values which are due to price changes (up or down) in particular assets, independently of general price movements. We may refer to this as current cost accounting (CCA) for depreciation. This method offers certain advantages over historical cost depreciation for purposes of income measurement. The Securities and Exchange Commission has recently issued a requirement that firms begin to include information based on current cost accounting in their financial statements. However, the correct techniques to use are currently under active debate in the accounting profession and no clear consensus has yet developed. It is clear that very considerable auditing and compliance problems would be raised by the methods which have been tentatively proposed.

A much simpler method of adjusting for inflation, current purchasing power (CPP) depreciation, would accomplish the major objective of preventing the effective rate of tax on capital income from varying with the inflation rate. Such an adjustment could be effected with relatively less controversial changes from the point of view of accounting doctrines, but assuring that all of the technical details have been correctly dealt with (recapture provisions, etc.) would be time consuming.

The extremely large revenue cost estimates associated with either replacement cost depreciation approach indicate the seriousness of the inflation effect on taxation of capital income. They also indicate, of course, the difficulty of attacking the problem within budget guidelines.

4. Phased Increase of Corporate Surtax Exemption

Small businesses that would benefit from an increase in the surtax exemption are generally owned by the wealthiest stratum of individuals. We have generally opposed such an increase but have gone along with the increase from \$25,000 to \$50,000 in the Tax Reduction Act (the President's tax cut proposals call for the continuation of the \$50,000 exemption).



While the surtax exemption is often touted as an encouragement of innovation and entry of new businesses, in fact the corporation income tax is not an inhibition to the formation of new enterprises or the introduction of innovative productive techniques. The law now permits small corporations to elect to by-pass the corporation income tax (Subchapter S), and by far the most common form of small business organization is not the corporation but proprietorship and partnership. Thus we do not regard it as likely that the stated purpose of the surtax exemption is actually served by it, and we would recommend against increasing it further.

5. Modification of Securities Regulations, Etc.

This item refers to the recommendations of Professor Richard S. Morse in the Commerce Department report entitled The Role of New Technical Enterprises in the U.S. Economy (pages 12-13 attached, Tab B). The specification of these proposals is in such a rudimentary form that it is not possible to comment intelligently on them, much less provide estimates of the revenue consequences of measures implementing them.

Attachments

cc: Secretary Simon
Deputy Secretary Dixon



Revenue Cost of Additional Options for Inclusion
in Administration Sponsored Jobs Creation Bill

Calendar Year

(\$ millions)

	Calendar Years					
	1976	1977	1978	1979	1980	1981
I. <u>Capital recovery:</u>						
A. <u>Increase in ADR from 20 percent to 40 percent range:</u>	350	1,900	2,700	3,300	3,600	3,800
Corporate	280	1,520	2,160	2,640	2,880	3,040
Individual	70	380	540	660	720	760
<u>Change depreciation allowances for Section 189 proposal:</u>	2,450	12,900	17,800	25,100	25,200	26,500
Corporate	1,960	10,320	14,240	20,080	20,160	21,200
Individual	490	2,580	3,560	5,020	5,040	5,300
B. <u>One-year writeoff of pollution control:</u>	900	1,600	1,700	1,500	1,500	1,400
Corporate	720	1,280	1,360	1,200	1,200	1,120
Individual	180	320	340	300	300	280
C. <u>Replacement cost depreciation:</u>						
<u>Current purchasing power (CPP) method (GNP deflator):</u>	13,500	14,400	15,500	16,500	17,700	18,900
Corporate	10,800	11,500	12,400	13,200	14,200	15,100
Individual	2,700	2,900	3,100	3,300	3,500	3,800
<u>Current cost accounting (CCA) method (PDE deflator):</u>	12,800	13,600	14,700	15,600	16,800	17,900
Corporate	10,200	10,900	11,800	12,500	13,400	14,300
Individual	2,600	2,700	2,900	3,100	3,400	3,600
II. <u>Corporate rate adjustments:</u>						
A. <u>Increased surtax exemption (phased in)</u>			833	1,642	1,810	1,965
B. <u>Tax relief for high technology corporations 1/</u>						

Office of the Secretary of the Treasury, Office of Tax Analysis

May 14, 1976

Note: Proposals are not additive. Proposals (with exception of (II.A.)) assume a July 1, 1976 effective date. Proposal (II.A.) assumes effective date of January 1, 1978. Item (II.A.) assumes enactment of President's January 1976 budget proposals.

1/ Proposals not sufficiently detailed to provide estimates of revenue impact.

Revenue Cost of Additional Options for Inclusion
in Administration Sponsored Jobs Creation Bill

Fiscal Year

(\$ millions)

		Fiscal Years				
		Trans Qtr:	1977	1978	1979	1980 : 1981
<u>I. Capital recovery:</u>						
A. <u>Increase in ADR from 20 percent to 40 percent range:</u>	91	1,000	2,212	2,934	3,417	3,678
Corporate	84	880	1,808	2,376	2,748	2,952
Individual	7	120	404	558	669	726
<u>Change depreciation allowances for Section 189 proposal:</u>	637	6,844	14,811	20,647	25,139	25,707
Corporate	588	6,016	12,084	16,868	20,116	20,628
Individual	49	828	2,727	3,779	5,023	5,079
B. <u>One-year writeoff of pollution control:</u>	234	1,290	1,639	1,622	1,500	1,461
Corporate	216	1,080	1,316	1,288	1,200	1,164
Individual	18	210	323	334	300	297
C. <u>Replacement cost depreciation:</u>						
<u>Current purchasing power (CPP) method (GNP deflator):</u>	3,510	15,600	14,835	15,890	16,980	18,150
Corporate	3,240	12,735	11,905	12,760	13,650	14,605
Individual	270	2,865	2,930	3,130	3,330	3,545
<u>Current cost accounting (CCA) method (PDE deflator):</u>	3,320	14,790	14,035	15,045	16,050	17,235
Corporate	3,060	12,045	11,305	12,115	12,905	13,805
Individual	260	2,745	2,730	2,930	3,145	3,430
<u>II. Corporate rate adjustments:</u>						
A. <u>Increased surtax exemption (phased in)</u>			375	1,197	1,717	1,880
B. <u>Tax relief for high technology corporations 1/</u>						

Office of the Secretary of the Treasury, Office of Tax Analysis

May 14, 1976

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1/ Proposals not sufficiently detailed to provide estimates of revenue impact.

in the decades ahead. If the future economic health of the country is to be insured, it is apparent that steps must be taken to improve the business environment. It is probably impossible to predict quantitatively the extent to which any specific legislative or administrative change might stimulate or expedite the generation of new business enterprises. Nevertheless, the following *recommendations* are suggested for executive and legislative action with the expectation that these actions would enhance the initiation and growth of new technically-based enterprises:

1. *Change Capital Gains Tax.* A reduced capital gains tax rate for direct investment in small technical enterprises should be an effective incentive to make venture capital available for "start-ups." Such an incentive should be available to both corporate and individual investors.
2. *"Founders' " Stock.* A new mechanism is needed to facilitate the acquisition of "Founders'" stock by officers, directors, and key employees during the formative years of a company. Care should be taken to prevent adverse tax consequences which negate the value of the stock in attracting key talent to the enterprise team.
3. *Recognize the Role of Corporate Investors.* The institutionalization of the venture capital community and the increasing use of the industrial corporate venture mechanism suggest that it would be desirable to allow corporate participation under both Sub-Chapter S and Section 1244 of the Internal Revenue Code.
4. *Tax Incentive for Direct Investment in Small Technical Enterprises.* An immediate deduction against income for individual, institutional and corporate investors for their direct investment in small technical enterprises would be an effective incentive for start-up financing. The investors would assume a zero base, and capital gains tax liability would be incurred only upon sale of the investment.
5. *Review SEC Rules.* SEC rules, notwithstanding Rule 144, continue to restrict the small-company-investor's liquidity. New combinations of holding periods and rates of distribution (for both private and public companies) should be considered.

6. *Review Reporting Procedures.* Reporting requirements under the rapidly growing state and federal regulations should be reviewed with the intent of simplifying the requirements for small companies.
7. *Review Tax and SEC Regulations.* General cost increases and inflation have made dollar limits in certain rules too small. In particular, for 1244 stock, the maximum asset value should be increased to \$1,000,000; the loss allowance should be increased to \$50,000 on an individual basis, and \$100,000 on a joint return basis. Similarly, the capitalization limit for a Regulation A registration should be increased to \$1,000,000. The small business 22% tax rate should be applied to the first \$100,000 of income rather than \$25,000. The tax-loss carry-forward period should be extended from five years to ten years.
8. *Review Incentives for Management.* For the new enterprise, the value of stock options as a management incentive can be restored by reducing the holding period for shares issued under a qualified plan and by arranging to defer tax liability for shares issued under a non-qualified plan. Other forms of financial and tax incentives should be developed for the management and key employees of the higher-risk new technical enterprise.

