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ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEETING

December 9, 1976
8:30 a.m.
Roosevelt Room

AGENDA

PRINCIPALS ONLY

1. Tax Policy Options for the Fiscal 1978 Budget — Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

DEC 8 1976

MEMORANDUM TO THE ECONOMIC POLICY BOARD

From: David F. Bradford DB and Burt Malkiel BM

Subject: Options for Additional Fiscal Stimulus

Attached is a memorandum on alternative methods of stimulating business investment via tax policy. This memorandum is for discussion at the meeting of Thursday, December 8 at 8:30 a.m.

Attachment

DRAFT
December 8, 1976

Options for Additional Stimulus to Provide Incentives for Private Investment

Troika 3, in its preliminary December forecast, concluded that with no new fiscal initiatives the growth rate in the economy during 1977 is likely to be somewhat slower than had previously been forecast and well below the rate assumed in the mid-year review. Growth that is too slow to make significant reductions in the unemployment rate is undesirable and may lead to a variety of public expenditure programs that interfere with our long-run goals of returning the economy to a stable non-inflationary growth path. Hence the Economic Policy Board requested that some options for additional stimulus be developed over and above those contained in the basic package described in Section I.

A major reason for the lower T-3 forecast was a scaling down of its very optimistic estimates for business fixed investment for 1977. Business fixed investment (BFI) has been running well below its normal share of GNP and even with the still substantial gains forecast next year the share of BFI in GNP will only recover to about 10 percent. This compares with an investment requirement of 12 percent of GNP estimated by the CEA last year as necessary to achieve full employment by 1980 and to achieve our longer-run environmental and energy goals. Because we are particularly concerned that the structure of the recovery not be too consumption oriented to make our longer-run goals unachievable, the additional stimulus measures considered here are all directed to business fixed investment. Of course, it should be emphasized that the President's basic program already includes significant individual tax cuts.

Reductions in the burden of tax on the income from capital can serve to stimulate the rate of private investment, whatever the level of capacity utilization or the state of market expectations. Even if the immediate objective is to provide near term investment incentives, only those tax measures which are regarded as desirable structural changes on a permanent basis should be proposed. This reflects the view that stability in tax policy is essential to orderly long-run investment planning.

In an attempt to maximize the stimulative effect of a given loss in revenue it is sometimes suggested that tax relief, or investment subsidies, be provided only with respect to "incremental" or "additional" investment. As a practical matter, there is no operational way to distinguish whether any investor's acquisition of capital goods is incremental or merely replacement. Any rule, such as last year's investment, or this year's depreciation allowance, cannot measure current incremental investment. The long-term effect of such provisions is to introduce wholly arbitrary disciminations in the availability of tax reductions. It is therefore recommended that tax measures to stimulate the rate of investment be applied across the board with no attempt made at precise definitions of "incremental" investment decisions.

Four options are presented below which provide incentives for private investment. All reduce 1977 business tax liabilities by $4 to $5 billion. The effects on FY 1977-79 receipts are described in Table 1.

Option I:

Advance the dividend deduction feature of the integration proposal. The Administration's proposal to integrate the individual and corporation income taxes includes a schedule for phasing in the deductibility of dividends paid by the corporation in calculating corporation income tax together with a phasing in of the gross up and credit at the corporate shareholder level. One way of providing additional stimulus and cash flow to corporations while maintaining the general thrust of the Administration's tax program would be to speed up the integration. Eliminating the double taxation of corporate dividends will, in the short run, reduce taxes on corporate income and bolster securities markets. Ultimately, the effects will be dispersed over the entire private sector.

A particularly simple way to advance this program would be to start the dividend deductibilty at a higher level immediately (as of January 1, 1977), holding at that level until it would be reached under the original schedule. In all other respects the integration schedule would be as originally proposed. By allowing deductibility of 30 percent of dividends starting January 1, 1977, calendar year 1977 liabilities would be reduced by approximately $4.8 billion. The phase in into the existing schedule of the integration proposal could be accomplished by maintaining the level of 30 percent dividend deductilibity until year 1981.

Option II:

This option has two parts:

- Move up by one year the whole schedule of integration of corporate and personal income taxes.

. Enhance the effectiveness of the investment tax credit.

The effect of moving up the schedule of phasing in the integration plan on calendar 1977 tax liabilities would be a reduction of $1.6 billion.

In its present formulation, the investment tax credit is larger for qualifying assets of longer depreciable life up to seven years; beyond that no increase in credit is provided, resulting in a bias against long-lived assets. The amount of credit which may be taken in any year is limited by the asset purchaser's tax liability. The maximum credit is the first $25,000 of tax plus 50 percent of the excess, with certain temporary exceptions for utilities, airlines and railroads which permit greater utilization of current year tax liability. This means that cyclically sensitive businesses, those suffering temporary adversity, and growing enterprises cannot fully utilize the credit.

For these reasons, the effectiveness of the present investment credit is less than its nominal rate of 10 percent (scheduled to revert to 7 percent in 1981). The following revisions in the investment tax credit would constitute desirable structural reforms and would provide some investment stimulus:

. The full amount of the credit earned by an investor each year would be creditable against all income tax liability and refundable to the extent it is in excess of current tax liability.

. The basis of qualified property--the amount subject to depreciation for tax purposes--would be reduced by the amount of the credit.

. The rate of credit would be increased to 12 percent on assets with useful lives of 12 years or more.

. The investment credit would be made permanent.

The calendar 1977 effect of these changes would be a $2.4 billion liability reduction. The total calendar 1977 liability reduction under this option is $4.0 billion.

Option III:

Structurally revise the investment tax credit as above, but increase the credit rate schedule to:

- 4 percent on assets with lives 3 or 4 years.
- 8 percent on assets with lives 5 or 6 years.
- 12 percent on assets with lives 7 through 11 years.
- 14 percent on assets with lives 12 years or more.

This plan reduces calendar 1977 liabilities by $4.4 billion.

Option IV:

Revise the investment tax credit as in Option II, and reduce the top corporate rate by an additional 2 points, to 44 percent. The advantage of this option is that it includes a broad reduction in the tax burden on corporate investment. But the considerable disadvantage is that a reduction in the corporate tax rate may be inconsistent with the objectives of the proposal to integrate personal and corporate taxes. To reduce the corporate tax rate, in effect, enhances the attraction of corporate retentions, increasing the tension between "ordinary income" and capital gains, which it is the intent of integration to reduce. This provides a reduction in calendar 1977 liabilities of about $4.4 billion.

Table 1

Revenue Losses of Investment Stimulus Options

(billions of dollars)

	Fiscal Year		
	1977	1978	1979
Option I - Advance integration by speeding dividend deduction only	2.1	4.9	5.2
Option II - Total	1.7	4.9	7.1
Advance whole integration schedule by one year	.7	2.5	5.1
Restructure investment tax credit including additional 2% for longer lived assets	.9	2.4	2.0
Option III - Restructure investment tax credit including additional 2% for longer lived assets and increase basic credit to 12% - total	1.9	4.3	4.0
Restructuring + 2%	.9	2.4	2.0
Increasing basic credit	.9	1.9	2.1
Option IV - Total	1.8	4.5	4.5
Restructure investment tax credit including additional 2% for longer lived assets	.9	2.4	2.0
Reduce top corporate rate 2 percentage points from 46% to 44%	.9	2.1	2.5

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1976

Note: On a liability basis, calendar year 1977 losses are: Option I $4.8; Option III 4.4
Option II - 4.0; Option IV - 4.4.

Details may not add to totals due to rounding

MINUTES OF THE ECONOMIC POLICY BOARD EXECUTIVE COMMITTEE MEETING

December 6, 1976

Attendees: Messrs. Simon, Seidman, Lynn, Greenspan, Richardson, Cannon, Gorog, O'Neill, Jones, Walker, Kendrick, Porter, Penner, Bradford, Galper, Hormats, Davie, Droitsch

1. Tax Policy Review

The Executive Committee reviewed a paper prepared by the Department of the Treasury on "Tax Policy Options for the Fiscal 1978 Budget." The discussion focused on the assumptions which underlie the popular notion of a fiscal dividend; the parameters within which tax policy options for the FY 1978 budget must be considered, including achieving a balanced budget in FY 1979, increasing the personal exemption from $750 to $1,000, and not increasing taxes from present levels for any taxpayer; specific tax proposals, including broadened stock ownership, a tax credit for mortgage investment under the Financial Institutions Act, accelerated depreciation for plants and equipment in areas of high unemployment, the taxable municipal bond option and changes in the tax exempt status of industrial development bonds, a sliding scale for capital gains and losses, and the trade-off between integration of the personal and corporate income taxes and reducing the corporate tax rate; and the need to agree on economic assumptions for purposes of the exercise.

Decisions

The Executive Committee will consider basic tax reform at the Tuesday, December 7, meeting. A paper prepared by the Treasury summarizing the basic tax reform preliminary report will be distributed.

Mr. Seidman will call a meeting this afternoon to consider economic assumptions for use in the tax policy exercise.

Treasury will prepare additional materials foxusing on the trade-off between corporate tax rate reduction and integration of the personal and corporate income taxes.

EYES ONLY

MINUTES OF THE ECONOMIC POLICY BOARD EXECUTIVE COMMITTEE MEETING

December 7, 1976

Attendees: Messrs. Simon, Seidman, Greenspan, Lynn, Richardson, Cannon, Zarb, Gorog, Malkiel, O'Neill, Kobelinski, Walker, Porter, Penner, Jones, Bradford, Goldstein

1. Basic Tax Reform

The Executive Committee discussed a paper, prepared by the Treasury, summarizing the basic tax reform preliminary report. The discussion focused on the revenue impact of the possible reform packages and the political difficulties of achieving basic tax reform. Secretary Simon indicated that the Executive Committee would meet for an hour, commencing at 8:30 a.m., on both Wednesday and Thursday to discuss basic tax reform. Executive Committee members were provided with a copy of the full draft report.

2. Economic Outlook

The Executive Committee reviewed the latest Troika II view of the economic outlook. The discussion focused on the lower level of economic activity during the fourth quarter of 1976, a modest scaling down of the investment forecast, the projected size of the Federal deficit, and the importance of confidence in investment decisions by corporations and small businesses.

Decision

The Executive Committee requested CEA and Treasury to jointly prepare a paper outlining possible tax changes to stimulate increased investment for consideration at the Thursday, December 9, Executive Committee meeting.

EYES ONLY

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