

**SAVINGS AND INVESTMENT PROVISIONS IN THE
ADMINISTRATION'S FISCAL YEAR 1998 BUDGET
PROPOSAL**

HEARING

BEFORE THE

**COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES**

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

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MARCH 19, 1997
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**SAVINGS AND INVESTMENT PROVISIONS IN
THE ADMINISTRATION'S FISCAL YEAR 1998
BUDGET PROPOSAL**

WEDNESDAY, MARCH 19, 1997

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:04 a.m. in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE

CONTACT: (202) 225-1721

March 4, 1997

No. FC-5

Archer Announces Hearing on Savings and Investment Provisions in the Administration's Fiscal Year 1998 Budget Proposal

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on the savings and investment provisions in the Administration's fiscal year 1998 budget proposal. The hearing will take place on Wednesday, March 19, 1997, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Oral testimony at this hearing will be heard from both invited and public witnesses. Also, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

The Administration's fiscal year 1998 budget proposal includes three savings and investment provisions: an exclusion (up to \$500,000) of capital gains on the sale of a principal residence, an expansion of Individual Retirement Accounts (IRAs), and a modification to the estate tax.

In announcing the hearing, Chairman Archer stated: "In his budget proposal, the President has recognized the need for tax incentives for savings and investment. I heartily concur in this need. I believe our country has an unacceptably low savings rate, and increased savings and investment will ultimately mean better employment prospects for Americans and a higher standard of living for our children and grandchildren. I also believe that reining in Federal spending and balancing the Federal budget will help to increase our national savings rate. Replacing our current tax system with a broad-based consumption tax remains my ultimate goal. I am convinced that this would be a more lasting way to encourage savings and investment and produce a stronger economy. But until that goal can be reached, we should enact changes to our tax system that reduce disincentives to save and invest. Accordingly, we should discuss not only the implications of the President's proposals but also more broad-based alternatives to the President's proposals."

FOCUS OF THE HEARING:

The focus of the hearing will be the savings and investment provisions (e.g., capital gains exclusion, IRA expansion, and estate tax relief) of the Administration's budget proposal for fiscal year 1998 and broad-based alternatives to those proposals.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business, Tuesday,

March 11, 1997. The telephone request should be followed by a formal written request to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee on staff at (202) 225-1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED.** The full written statement of each witness will be included in the printed record, in accordance with House Rules.

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies of their prepared statement and a 3.5-inch diskette in WordPerfect or ASCII format, for review by Members prior to the hearing. Testimony should arrive at the Committee office, room 1102 Longworth House Office Building, no later than Monday, March 17, 1997. Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement and a 3.5-inch diskette in WordPerfect or ASCII format, with their address and date of hearing noted, by the close of business, Wednesday, April 2, 1997, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments. At the same time written statements are submitted to the Committee, witnesses are now requested to submit their statements on a 3.5-inch diskette in WordPerfect or ASCII format.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the

Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at [HTTP://WWW.HOUSE.GOV/WAYS MEANS/](http://www.house.gov/ways_means/).

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-225-1904 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman ARCHER. The Committee will come to order. The Chair would invite guests, staff, and Members to take seats. We have a very, very important witness to lead off the hearing today, and we want to be able to be sure and hear him. Actually, we have three very important witnesses at the witness table. Today, the Committee continues our series of hearings on the tax provisions in the President's budget. Today's hearing will focus on incentives for savings and investment.

In the President's budget proposal, he includes a capital gains exclusion for principal residences and an expansion of IRAs and changes to the rules for deferred payments of estate taxes on farms and small businesses. In this hearing, we will examine not only these incentives but more broad-based alternatives as well. In particular, I welcome the support we will hear today from Democrats for a broad-based capital gains and estate tax relief.

The reduction in the capital gains tax and the death tax is not and should not be a partisan issue. All Americans will benefit from greater savings and investment. I look forward to a bipartisan effort to change our tax system to one that encourages, rather than deters, savings and investment.

[The opening statement of Mr. Thomas follows:]

Statement of the Hon. Bill Thomas
21st District, California
Committee on Ways and Means
March 19, 1997

I appreciate the opportunity this hearing will provide for Committee members and the public to examine the need for a full expansion of the Individual Retirement Account as proposed in my "Super IRA" bill, H.R. 446. The bill's 115 cosponsors, including 19 members of this Committee, already recognize that H.R. 446 gives the taxpayers the best options for saving more for their retirement.

The present IRA fails to address potential savers' concern about paper work, family needs and retirement. Most taxpayers get tax deferral with an IRA. That is attractive only if the taxpayer is willing to bear the burden of saving through this device. Deferral does not overcome their resistance to putting money away.

There are penalties for those using today's IRA. Taxpayers lose deductions for contributions as incomes rise. They have to keep track of their contributions to other kinds of plans. Spouses staying in the home only get a small deduction if their partner is participating in a pension plan.

Funds are illiquid too. Families facing educational, home ownership or unemployment needs often can use their own money only if they pay a 10% early withdrawal penalty to Uncle Sam.

Finally, taxpayers are not going to get better educated about the product because no one will reach out to them. Advertising for IRAs dropped after restrictions were enacted in 1986. It hardly seems a coincidence that contributions dropped by 40% in 1987 and that even one half of those still eligible to deduct contributions thought they were unable to do so. No one has the incentive to correct that misunderstanding though consumer education today, especially when you have to explain the interaction of IRA and pension law to people who just want a simple vehicle for savings.

What the Super IRA does is redesign the product from the consumers' point of view. H.R. 466 will phase out income limits on deductible contributions while creating a new "Backloaded" IRA that will produce tax free income. The bill completely eliminates the unfair spousal IRA rules and the coordination contribution rules. To give taxpayers the assurance that they can meet family needs, the bill eliminates the 10% early withdrawal penalty on Funds used for education, buying a home or durations of unemployment.

Taxpayers used to find IRAs very attractive before 1986. Nearly three-quarters of the contributions used to come from families with under \$50,000 in income. Congress took a good thing and made it too complicated for those same people. This hearing will give everyone an opportunity to debate the issues and see why H.R. 446 is the preferred solution.

Chairman ARCHER. Our first witness this morning is a gentleman well known to the Committee, a Member of the Committee, the gentleman from Louisiana, Jim McCrery.

You may proceed, Mr. McCrery.

**STATEMENT OF HON. JIM MCCRERY, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF LOUISIANA**

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Chairman, in the last Congress, I, along with a few others on the House side and Senator Dole on the Senate side, introduced the Family Business Protection Act. In the House, it was H.R. 2190. We had about 175 or so cosponsors and had bipartisan support for the bill. A version of H.R. 2190, in fact, a pretty close version, was included in the reconciliation bill that was sent to the President and vetoed by the President.

Since the beginning of this Congress, I have been working with several Members of this Committee and others on a new version of the Family Business Protection Act, and we will be introducing this soon. Essentially, the components of the new bill will include a \$1.5 million exclusion from the estate tax for closely held family businesses, family farms, and the like. We will index that exclusion for inflation, and any excess value over that exclusion will be taxed at a rate 50 percent less than the current rate.

Second, the legislation will make the unified credit a real exemption from the estate tax. What does that mean? That means that we will, in effect, move the tax rates applicable to estates up to begin at the level of the exemption. In other words, in the current law, you exempt \$600,000 of the estate from taxation, but the initial rate of tax is not 18 percent, which is the lowest estate tax rate; it is 37 percent. What we do in this bill is we move the rates up to correspond with the first tax dollar of the estate so that the initial rate applied to the estate is 18 percent above the exemption.

And we also include an increase in the unified credit from the current law level of \$600,000 up to \$1 million over a 5-year period, and then, we index that exemption or that unified credit for inflation. And finally, working with Mr. Herger and Mr. Houghton and others, our legislation will offer some additional changes dealing with the election of the special use valuation for family farms and ranches, conservation easements, and historic property.

Mr. Chairman, the estate tax has become a burden on average families in this country, particularly families that have saved and invested and built small businesses, family farms. I do not think the estate tax was ever meant to be a burden on those families. It needs to be addressed. I am hopeful this Congress will do it.

Thank you.

[The prepared statement follows:]

**Statement of Hon. Jim McCreery, a Representative in Congress from the
State of Louisiana**

Thank you Mr. Chairman for giving me the opportunity to testify before the Committee today. I appreciate the time you have allotted my colleagues and me to talk about one of the greatest disincentives to lifetime savings that exists in the tax code today—the estate and gift tax.

There has been a direct connection between death and taxes for about 200 years. In fact, the year 1797 was the first time the United States government imposed a death duty in the form of a stamp tax. Between 1797 and 1916, the year Congress first enacted a federal estate tax, inheritance duties were imposed twice to raise revenue during times of war. Both instances collected very little money, even by that day's standards.

As members of this committee, we have listened to hours of testimony describing the dismal savings rate of the U.S. population. We have proposed and even passed legislation that created incentives in the tax code for savings. Yet by some perverse

logic, our tax code punishes those people in death who have done exactly what we hope the rest of the country will do during their lifetime—save and invest.

Mr. Chairman, conventional wisdom suggests that most people believe they are never going to be subject to estate taxes. In their minds, only the very wealthy have estates large enough. I believe, however, more often than not, conventional wisdom is being proven wrong and that we are at the beginning of a period in our history where average Americans who have built family businesses, operated ranches and farms, and saved frugally and invested wisely for most of their lives, will be unfairly subjected to estate taxes.

In fact, in a letter to you dated January 21, 1997, the Joint Committee on Taxation said that since 1993, estate and gift receipts have been averaging double digit rates of growth. They laid out four possible reasons: first, the amount of wealth exempt from the estate and gift tax was not indexed to inflation; second, we have witnessed an unusually large increase in the value of the stock market. This means that the value of estates that would already be subject to tax has increased tremendously and more estates have been bumped into taxable status; third, the number of people who are 85 years old or older is growing at a rate of 3.5% annually, thereby increasing the mortality rates for this decade. And fourth, the 100% marital deduction included in the 1981 Economic Recovery Tax Act delayed the payment of estate tax until the surviving spouse died. On average, spouses tend to live 10 years longer than their mates, and therefore this decade will see more estates that used the marital deduction, subject to tax.

Since the 103rd Congress, I have introduced legislation that would address the estate tax burden imposed upon closely held family businesses and farms. According to the Small Business Administration's Office of Advocacy, more than 70% of all family businesses do not survive through the second generation and fully 87% do not make it to the third generation. Further, according to the Tax Foundation, high estate taxes looming on the horizon provide a disincentive for owners of family owned businesses to expand their operation and create new jobs. In fact, current estate tax rates produce the same disincentives to growth as a doubling of current income tax rates.

In the 104th Congress, H.R. 2190, the Family Business Protection Act, had 175 cosponsors and enjoyed wide bipartisan support from both urban and rural members as well as conservative Republicans and liberal Democrats. A modified version of this legislation was included in the reconciliation bill which was vetoed by President Clinton.

Since the beginning of this Congress I have been working with a group of members on this committee to expand the provisions of the Family Business Protection Act to incorporate sections that address many of the underlying reasons that, if nothing is done, many more average families will be subject to the estate tax.

Essentially, the components of the "Family Business Protection Act" will include a \$1.5 million exclusion, indexed for inflation, from estate tax for the value of a closely held family owned business. The excess value over the \$1.5 million would be taxed at 50% of the current rate.

Second, our legislation will make the unified credit a real exemption. You may be asking what is the difference? The difference is that we talk about the fact that there is a unified credit of \$600,000, but that really is not true.

The tax code provides for a bottom rate of 18%. In reality, no one ever pays that. The unified credit only gets rid of the tax liability on \$600,000, so currently the lowest rate that anyone would ever pay is 37%. Essentially, if today a person had an estate of \$600,001, of that \$1.00, 37 cents would go to the Treasury. What we are proposing is that the credit be made an exemption so that the lowest rate of 18% applies to the first dollar of value in a person's estate upon which they actually pay the tax. The rates would then be graduated, as under current law.

In conjunction with this, our legislation will also include an increase the unified credit from the current law level of \$600,000 to \$1,000,000 over five year, indexed for inflation.

Finally, our legislation will offer some additional changes to current law dealing with the election of the special use valuation for family farms and ranches, conservation easements, and historic property.

Mr. Chairman, the estate tax was never intended to be a burden on average families who have wisely saved and invested over their lifetime. What we are finding, however, is that for families all over this country this tax is indeed becoming a burden. They are having to sell their homes, businesses, and farms to meet a tax bill that is imposed because someone passed away. Our bill is targeted to give relief to those families.

Again, thank you for this opportunity to testify. I will be happy to take any questions at the appropriate time.

Chairman ARCHER. Thank you, Mr. McCrery.

Mr. Rangel, would you like to make any sort of a preliminary statement and extend your own welcome to the panel of witnesses?

Mr. RANGEL. That is very kind of you, Mr. Chairman. I would like to join with you in hoping that both the Republicans and the Democrats, taking suggestions and recommendations made by our Members, will come up with a bill that will present to the American people a balanced budget that we all can agree to. This is especially so since your leadership has suggested removing tax cuts from the budget discussion, temporarily, at least, and all my colleagues share that feeling.

Thank you.

[The opening statement follows:]

Statement of Hon. Charles B. Rangel, a Representative in Congress from the State of New York

I am delighted to be here with my colleagues today to talk about the choices we will have to make if we are to balance the budget in the next several years.

I am pleased to listen to today's witnesses about cuts in capital gains taxes, expanded IRA accounts, and estate and gift tax relief in the context of reducing our deficit.

A good case will be made for each of these tax cut ideas from the viewpoint of its proponents.

We will hear about the potential that each of these proposals has for increasing savings and investment in this country. We may hear some skepticism.

Tax cuts are popular. Somebody always benefits from a tax cut. And, this will be reflected in the enthusiasm that some of our witnesses may have for various cut ideas.

I am, like any politician, in favor of cut cuts. In fact, I have said that I could even be in favor of a capital gains tax cut if it were in the context of a fair and balanced plan. So, I am here today to listen to the reasons why we should include them in whatever budget bill we may end up with this year. But, tax cuts should not come at the wrong time and they should be focused on those who need them most.

And, tax cuts must be paid for . . . that is, they must be paid for if we are serious about reducing the deficit at the same time.

Who will pay for these tax cuts? Will it be the large corporations who eloquent and sophisticated representatives sat in this room last week and opposed the President's revenue raisers? Or will it be the poor and the disadvantaged who have only begun to feel the effects of the policies enacted in the last 2 years to pay for other initiatives?

In the end, it is all about choices.

We will have to make difficult choices about how to spend our scarce resources. We will have to decide what is best for our economy and for our citizens. Not just what will make them feel good next April 15 when they fill out their tax returns, but instead what will add to their changes for prosperity year after year.

I have made my choice. I have come to the conclusion that the best thing for our country right now is deficit reduction.

This will help to keep interest rates down and to control the pressure on the future generations who will have to pay for the debts of our generation. And it will prevent any unfairness in the way any possible tax cuts are paid for.

The "Blue Dog" Democrats have made their choice. They have put forth a plan for a balanced budget without any tax cuts. They have said that deficit reduction is more important right now. I am glad we agree on this issue.

Apparently, Speaker Gingrich has made his choice, too. Yesterday's Washington Post reported that the Speaker has given up on his "crown jewel." He has dropped the idea of including a tax cut in the budget bill.

I am glad that the Speaker has come around to that conclusion because the task of deficit reduction is made undeniably easier if there are no tax cuts in the final package.

If we can first get our fiscal affairs in order, then we can begin to consider how best to enhance the opportunities for prosperity of each of our citizens.

I prefer the idea of investing in human capital. Some of the proposals we will consider today will support tax relief for investing in physical and/or financial capital. That is not enough. Nor is it the correct focus, in my opinion.

A Wall Street Journal survey of 1,500 economists indicated that the vast majority of them do not believe that proposals like the ones before us today will do much, if anything, for the economy. However, they gave much higher marks to the notion of investing in education in order to improve the abilities of our own workforce.

I believe in that. I believe in making people capable themselves of improving their circumstances in life.

If government is going to maintain the ability to help our citizens do that, then we must be cautious. We must craft our proposals carefully and spend our money wisely.

We must be prepared to make the tough choices.

Mr. MCCRERY. Mr. Chairman, I beg your forgiveness. I did not request that my written testimony be included in the record. I will do so at this time.

Chairman ARCHER. Without objection, as usual, the written testimony of every witness in the hearing today will be included in the record.

Mr. MCCRERY. Thank you.

Chairman ARCHER. And all witnesses are encouraged to keep their verbal testimony to within a 5-minute limit.

Our next witness is the gentleman from Massachusetts, also a well-known Member of the Committee, Richard Neal.

Mr. Neal, welcome to your own Committee.

Mr. NEAL. Thank you.

Chairman ARCHER. And you may proceed.

STATEMENT OF HON. RICHARD NEAL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. NEAL. Thank you, Mr. Chairman.

I want to talk to you this morning about an issue that has been important to me since I arrived in the Congress, and that is the issue of savings for retirement. Alan Greenspan has said time and again—and I know it sounds trite on the surface, but nonetheless, it is critical, that the number one economic problem that faces America today is our low national savings rate. As the baby boomers grow older, they are faced with many difficult financial decisions, such as the cost of long-term care for elderly parents, the expense of higher education, and saving for retirement.

The May issue of the Atlantic Monthly coined the phrase social insecurity. We are beginning to face what has commonly been referred to as the graying of America. Within 30 years, one out of every five Americans will be over 65, and in 15 years, the baby boomers will begin turning 65. The baby boomer generation consists of 76 million members, and this will result in Social Security beneficiaries doubling by the year 2040. Less than half of all Americans are currently covered by private sector pensions, and 51 million Americans have no pension plan at all.

We have an opportunity to encourage these individuals to begin to save. Congressman Thomas and I have introduced bipartisan, comprehensive individual retirement account legislation, commonly referred to as the Super IRA. We have 110 cosponsors in the House, including 18 Members of this Committee, and Senators

Roth and Breaux have companion legislation in the Senate, and they now have 49 sponsors. Those who watch tax policy have dubbed this the year of the great tax cut compromise. And while it is still doubtful that we are going to reach a total agreement this year, I do believe there is real consensus on the expansion of IRAs. Both the Senate Democratic and Republican leadership have introduced legislation which expands IRAs. The House Democratic bill is being introduced today. President Clinton has included expanded IRAs in the new type of IRAs in his budget.

Most of us agree that IRAs will help to increase savings and make individuals more personally responsible for their retirement. Deputy Secretary Summers testified before the Senate Committee on Finance and said during his testimony that there are two general ways to address the effect of the low national savings rate on economic growth and retirement income security. The first way is to reduce the deficit, and the second is to improve current incentives to promote savings, especially retirement savings. President Clinton's proposal expands income limits, creates new backloaded IRAs, and eliminates the 10-percent penalty for early withdrawal under certain circumstances. These purposes are to pay postsecondary education; to purchase a first-time home, to cover the cost of unemployment, and also to cover medical expenses of certain close relatives who are not dependents.

Under our Super IRA legislation, all Americans would be eligible for fully deductible IRAs by the year 2001. Taxpayers would be offered a new choice called the IRA-Plus Account. Under the IRA-Plus Account, contributions would not be tax deductible; however, earnings on the IRA-Plus Accounts can be withdrawn tax free if the account is open for at least 5 years and the IRA holder is 59½ years old. A 10-percent penalty would apply to early withdrawals unless the withdrawal meets one of three special purpose distributions. These special distributions are to buy a first-time home; to pay educational expenses; or to cover any expenses during the period of unemployment compensation for at least 12 weeks.

These are all legitimate purposes. Otherwise, the contributions would be locked up for retirement. IRA and 401(k) contributions would not have to be coordinated. It seems to me this legislation is one of the best options that is available to all of us, and I believe it is important to enact some sort of incentive this year to help individuals save for retirement. As Professor Stephen Venti of Dartmouth testified recently before the Senate Finance Committee, the long-term benefits of the provision far outweigh the revenue costs.

Mr. Chairman, this legislation in previous sessions was known, I believe, as the Bentsen proposal some years back, and a former Member and colleague on this Committee, Jake Pickle, also offered this proposal many times before. It seems to me that we have a unique opportunity, given the discussion that is occurring today about entitlement reform, and just as importantly, it is consistent with all discussions we have had about personal responsibility. This is a critical issue as we proceed to the new century, and I hope Members of this Committee, 18 of whom have already signed onto this legislation, will, I think, have the opportunity to promote this legislation as it comes before the full Congress.

[The prepared statement follows:]

**Statement of Hon. Richard Neal, a Representative in Congress from the
State of Massachusetts**

Mr. Chairman, first of all I would like to thank you for allowing me to testify about an issue which is of vital importance to our economic security. This issue is savings for retirement. Chairman Alan Greenspan of the Federal Reserve has stated our number one economic problem is our low national savings rate.

As baby boomers grow older they are faced with many difficult financial decisions such as the cost of long-term care for elderly parents, the expense of higher education, and saving for retirement. The May issue of Atlantic Monthly coined the phrase "social insecurity."

We are beginning to face what has been commonly referred to as the graying of America. Within thirty years one out of every five Americans will be over sixty-five. In fifteen years, the baby boomers will begin turning sixty-five. The baby boomer generation consists of 76 million members and this will result in Social Security beneficiaries doubling by the year 2040. Less than half of all Americans are covered by private sector pensions. Fifty-one million American workers have no pension plan.

We need to encourage individuals to save. Congressman Thomas and I have introduced bipartisan comprehensive Individual Retirement Account (IRA) legislation, commonly referred to as the "Super IRA." We have over 110 cosponsors in the House, including eighteen Members of this Committee. Senators Roth and Breaux have introduced companion legislation in the Senate and they now have forty-nine cosponsors.

Those who watch tax policy have dubbed this year as "The Year of the Great Tax Cut Compromise." It still is doubtful if we will reach agreement this year, but I believe there is real consensus on the expansion of IRAs. Both the Senate Democratic and Republican leadership have introduced legislation which expands IRAs. The House Democratic leadership is introducing legislation today. President Clinton has included expanded IRAs and a new type of IRAs in his budget. Most of us agree IRAs will help increase savings and make individuals more personally responsible for their retirement. Recently, Deputy Secretary of the Treasury Lawrence Summers testified before the Senate Committee on Finance. During his testimony, he stated there are two general ways to address the effect of the low savings rate on economic growth and retirement income security. The first way is to reduce the deficit and the second is to improve current incentives to promote savings, especially retirement savings. We can accomplish both of these goals by enacting a budget which balances by 2002 and includes an expansion of IRAs.

President Clinton's IRA proposal expand income limits, creates new backloaded IRAs, and eliminates the 10 percent early withdrawal for certain purposes. These purposes are to pay post-secondary education costs, to purchase a first home, to cover costs of unemployment, and to cover medical expenses of certain close relatives who are not dependents. Under the backloaded IRA, contributions would not be tax deductible, but if contributions remain in the account for at least five years, distributions of the earnings on the contribution would also be tax-free.

Under the Super IRA legislation, all Americans would be eligible for fully deductible IRAs by the year 2001. Taxpayers would be offered a new IRA choice called the "IRA Plus Account." Under the IRA Plus Account, contributions would not be tax deductible. However earnings on IRA Plus Assets can be withdrawn tax-free if the account is open for at least 5 years and the IRA holder is at least age 59 and . A 10 percent penalty would apply to early withdrawals unless the withdrawal meets one of the three special purpose distributions. The special purpose distributions are: to buy a first time home, to pay educational expenses, or to cover any expenses during period of unemployment compensation for at least 12 weeks. These are legitimate purposes. Otherwise, the contribution should be locked up for retirement. IRA and 401(k) contributions would not have to be coordinated.

I believe the super IRA legislation is the best option before us. However, I believe it is important to enact some type of incentive to help individuals save for retirement. Individuals need to become more personally responsible for their retirement. Professor Stephen Venti of Dartmouth testified before the Committee on Finance that IRAs work. He stated: "The long-term benefits of the provision far outweigh the revenue costs."

There is skepticism among economists about IRAs generating new savings. Professor Venti testified that many of those who contribute to IRAs are saving funds they would not otherwise be saving. One of our panelists will testify today that IRAs do not create new savings and just cause a shifting of funds. I believe there is enough evidence that IRAs promote savings. I cannot think of a better alternative. IRAs do

create new savings and the shifting of savings usually locks up existing savings for retirement.

Another import aspect of increasing savings is marketability. Individuals have to want to save. We need to offer products that they want and will make savings easy for them. Deputy Secretary Summers testified that IRA proposals must be designed to reinforce and encourage psychological factors that could increase the efficiency of IRAs in promoting savings. A 1990 Gallup survey done for Fidelity Investments showed 71 percent of the respondents preferred expanding the tax incentives for IRAs to close the gap between their retirement needs and their retirement checks from institutional sources. This same answer was given by 69 percent of the respondents in a 1996 Luntz-Lake survey conducted for the Savings Coalition.

IRAs provide the right type of vehicle for long term savings for retirement. Those who invest in IRAs usually invest for the long term. For example, 86 percent of IRA assets at Fidelity are invested in equity funds, as compared to an average of 56 percent in non-retirement accounts. This shows individuals can make intelligent investments for their retirement. Most IRA account holders are truly thinking about retirement when they make their investment decisions.

Millions of Americans do not have adequate retirement savings and are worried about their retirement. Even with Social Security, a couple earning \$50,000 a year needs to have saved about \$225,000 by retirement to maintain their standard of living over a 35 year retirement. A USA Today/CNN Gallup Poll showed four out of ten Americans sets aside less than \$1000 a year for retirement.

The Super IRA legislation is based on legislation crafted by Congressman Pickle and Senator Bentsen. This legislation is not a panacea for social insecurity that we will inevitable face, but it is a reasonable, concrete solution to make retirement savings easier. I encourage you to work with me on the passage of expanded tax incentives for IRAs. This type of proposal will have a drastic impact on millions of Americans. The bottom line is more Americans will be able to be personally responsible for their retirement.

As the graying of America continues Congress will have to face many difficult decisions about the future of Social Security, but in the meanwhile, we can and must all agree on making retirement savings easier.

Chairman ARCHER. Thank you, Mr. Neal.

Our next witness is also a Member of the Committee, the gentlelady from the State of Washington, Jennifer Dunn.

You may proceed.

**STATEMENT OF HON. JENNIFER DUNN, A REPRESENTATIVE
IN CONGRESS FROM THE STATE OF WASHINGTON**

Ms. DUNN. Thank you, Mr. Chairman.

And my colleagues, I appreciate the opportunity to testify before you today on two matters that I believe are critical to the economic security of every American: The estate tax and capital gains relief. My message is quite clear: The President's budget simply does not add up in a way that is fair to taxpayers. First, it adds up to a tax increase over 10 years. Second, it doesn't add up to a balanced budget. Both a balanced budget and meaningful tax relief are desperately needed.

I have introduced legislation, the Return Capital to the American People Act, the ReCAP Act, which provides a capital gains reduction for both individuals and for corporations. This is legislation that is sponsored in the Senate by Senator Mack, and Mr. Herger has joined me in proposing this legislation. I won't go into the specifics of the bill since you have a detailed description, but I do want to briefly point out that the measure is broad based, and the capital gains measure includes a 50-percent capital gains deduction, indexation of assets to eliminate inflationary gains, and venture

capital incentives to help cash-starved small and startup businesses.

I will tell you that I believe an across-the-board cut in the capital gains rate for both individuals and corporations will do more to boost our Nation's economy, more to create jobs, more to enhance U.S. competitiveness worldwide, and more to increase savings and investment than any other single piece of legislation we can enact. While there are many reasons to support a reduction in the capital gains rate, I would like to highlight what I believe to be the most compelling parts of the ReCAP Act.

One: A low capital gains rate benefits all Americans. My proposal is fair to all income groups and sectors of our economy. Two: Low capital gains is important for our future and our Nation's ability to save and to invest. Three: Lowering the capital gains rate unlocks investment and America's true economic potential. Four: Lower capital gains will increase Federal revenues, just as was done in the twenties, the sixties, and the eighties, and help us reach the goal of a balanced budget. Finally, with respect to capital gains, I would suggest that sound tax policy and economic considerations argue for the inclusion of a corporate capital gains rate reduction comparable to the percentage of the individual rates cut.

Second, on the estate tax; this is also called the death tax, or, some of the people I represent call it the agony tax. One of the most compelling aspects of the American dream is to make life better for your children and your loved ones. Yet, the current tax treatment of estates is so onerous that when one dies, their children are many times forced to sell and turn over more than half their inheritance simply to pay the taxes. This is wrong, and I hope we can all agree that something should be done.

More than 70 percent of family businesses and farms do not survive through the second generation. Eighty-seven percent do not make it through the third generation. By confiscating between 37 and 55 percent of a family's aftertax savings, the estate tax punishes lifelong habits of savings. It discourages entrepreneurship and capital formation. It penalizes families, and it has an enormous negative effect on other tax revenues. By today's tax system, it is easier and cheaper to sell the business before death rather than to try to pass it on after.

I would like to talk briefly about solutions. I am a strong advocate of the elimination of all estate tax, and I have cosponsored two separate pieces of legislation in the 105th Congress to provide for that repeal. One is the Crane-Hulshof bill; the other is the Cox bill. Unfortunately, a complete repeal of the estate tax is not a viable option, considering the President's opposition. I am working with a number of our colleagues on the Committee to draft a bipartisan proposal. I believe such a proposal should be based on a three-pronged approach: One, increase in the unified credit; two, targeted relief for family businesses and farms; and three, to make it broader, some level of rate reduction.

I had hoped we would have introduced our bipartisan proposal at the time of this hearing, but it could not occur. However, I am confident that through our continued vigilance, we can draft a bipartisan proposal that will be a vehicle for relief as the Congress moves forward.

Thank you, Mr. Chairman, for your leadership in both of these areas, and thanks to the Committee for your attentiveness this morning.

[The prepared statement follows:]

Statement of Hon. Jennifer Dunn, a Representative in Congress from the State of Washington

Thank you, Mr. Chairman.

My colleagues, I appreciate the opportunity to testify before you here today on two matters that I believe are critical to the economic security of every American—estate tax and capital gains relief.

My message is quite clear—the President’s budget simply does not add up in a way that’s fair to taxpayers. First, it adds up to a tax increase over 10 years. Second, it doesn’t add up to a balanced budget. Both a balanced budget and meaningful tax relief are desperately needed.

CAPITAL GAINS

On March 12th, I introduced the Return Capital to the American People Act (ReCAP Act). This legislation provides a capital gains reduction for both individuals and corporations and will do more to boost our nation’s economy, more to create jobs, more to enhance U.S. competitiveness worldwide, and more to increase savings and investment than any other single legislative change we can enact.

For established, successful businesses, for struggling entrepreneurs, and for middle-class families across the country, this measure represents the most serious effort to unlock billions of dollars in investment providing for expanded growth and job creation. I will not go into many specifics of my bill, as a detailed description is provided for in the materials before you. I will, however, briefly point out that the measure is broad-based and includes: a 50 percent capital gains deduction, indexation of assets to eliminate inflationary gains and venture capital incentives to help cash-starved start-up and small businesses.

While there are many reasons to support a reduction in the capital gains rate, I would like to highlight what I believe to be the most compelling case for enactment of the ReCAP Act.

A low capital gains rate benefits all Americans. This bill is fair to all income groups and sectors of our economy. Many of the so-called “rich” who would benefit from a cut in capital gains taxes are only rich for one year. A family in Eatonville that sells its house, an owner in Issaquah who sells a small business, a worker in Bellevue selling stock received through an employee stock option, and a retiree in Auburn selling an asset and planning to live off the proceeds would all be considered wealthy on current “tax distribution” tables. For example, a review by the Joint Committee on Taxation on capital gains realizations for the period 1979–1983 shows that nearly 44% of tax returns claiming a capital gain during that 5 year period claimed only one capital gain. Most of these people aren’t rich, regardless of what statistics say. They merely have one year of inflated income because they realized a big capital gain.

Furthermore, an analysis of 1993 tax returns found that nearly 50% of the tax returns reporting capital gains were filed by taxpayers with less than \$40,000 in adjusted gross income. Of tax returns claiming a capital gain, nearly 60% of those returns are filed by taxpayers with less than \$50,000 in adjusted gross income.

Low capital gains rate is important for our future and our nation’s ability to save and invest. Americans do not save enough. If you look at our tax laws, you will see why. Instead of encouraging people to save, the tax code often punishes people who save and invest. This is primarily due to the fact that the income tax hits savings more than once—first when income is earned and again when interest and dividends on the investment supported by the original savings are received. This system is inherently unfair because the individual or company that saves and invests pays more taxes over time than if all income were consumed and no savings took place. We need to change this. Without savings, a person cannot buy a house, a business cannot purchase new equipment, and our economy cannot create jobs. Unless we can raise our national savings rate, our standard of living, and our children’s and grandchildren’s standards of living will not grow.

Lowering the capital gains rate un-locks investment and America’s true economic potential. High capital gains taxes can prevent someone from selling an asset and paying the tax. This is the “lock-in effect”: when a person will not sell an investment and reinvest the proceeds in a higher paying alternative if the capital gains taxes he or she would owe exceed the expected higher return on the original investment.

This lock-in effect limits economic growth and job creation. Capital stays locked in an investment instead of being free to go to a person who wants to hire new employees in her consulting business. Lower capital gains taxes will reduce the lock-in effect and free up capital for small businesses, first-time home buyers, and entrepreneurs.

Lower capital gains will increase federal revenues and thus help reach the goal of a balanced budget. History indicates that lower capital gains taxes have a positive impact on federal revenues. During the period of 1978 to 1985 the marginal federal tax rate on capital gains was cut from almost 50 percent to 20 percent—but total individual capital gains tax receipts increased from \$9.1 billion to \$26.5 billion. After surging to \$326 billion in 1986 (the year before the 1986 rate increase took effect), capital gains realizations have trended down and remained at less than \$130 billion per year in the 1990s.

Given the increases in the stock market, inflation and growth of the economy since the late 1980s, realizations and taxes paid are certainly being depressed by the current high capital gains rates.

Rather than discouraging American workers and businesses, the Federal government ought to simply get out of the way. Lower capital gains taxes—as embodied in this bill—leave more vital capital in the hands of businesses, investors and entrepreneurs. They know a lot more than the Federal government ever can or will about creating jobs and products in a competitive marketplace.

I would also point out that sound tax policy and economic considerations argue for inclusion of a corporate capital gains rate reduction comparable to the percentage as individual rates are cut.

History proves that capital gains tax reduction is the right course to take. In the past, reductions always have boosted the nation's economy and increased tax revenues to the federal government. If a goal of this Congress is to pass legislation promoting economic opportunity and growth in America, then common sense suggests that we enact the ReCAP Act.

Estate Tax Relief

One of the most compelling aspects of the American dream is to make life better for your children and loved ones. Yet, the current tax treatment of estates is so onerous that when one dies, their children are many times forced to sell and turn over more than half of their inheritance to just pay the taxes. This is wrong and I would hope that we all can agree upon that and that something must be done.

More than 70% of family business and farms do not survive through the second generation. 87% do not make it through the third generation. By confiscating between 37% and 55% of a family's after tax savings, the estate tax punishes life-long habits of savings, discourages entrepreneurship and capital formation, penalizes families, and has an enormous negative effect on other tax revenues. By today's tax system, it is easier and cheaper to sell the business before death rather than try to pass it on after.

I would like to talk briefly about solutions. I am a strong advocate of elimination of all estate taxes and have cosponsored two separate pieces of legislation in the 105th to provide for that repeal. Unfortunately, a complete repeal of estate taxes is not a viable option considering the President's position.

I am working with a number of our colleagues on the Committee to draft a bi-partisan proposal. I believe that such a proposal should be based upon a three-pronged approach: 1) increase in the unified credit, 2) targeted relief for family businesses and farms, and 3) some level of rate reduction.

I had hoped that we would have introduced our bi-partisan proposal by the time of this hearing. Unfortunately, this could not occur. However, I am confident that through our continued vigilance we can draft a bi-partisan proposal that will be a vehicle for relief as the Congress moves forward.

Thank you, Mr. Chairman for your leadership in both these areas. And thank you to the Committee colleagues for your attentiveness this morning.

Chairman ARCHER. Thank you, Ms. Dunn.

Our final witness in this panel is another well-known Member of our Committee, Congressman Jon Christensen from Nebraska.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Christensen, you may proceed.

**STATEMENT OF HON. JON CHRISTENSEN, A REPRESENTATIVE
IN CONGRESS FROM THE STATE OF NEBRASKA**

Mr. CHRISTENSEN. Thank you.

This past week, I had the opportunity to convene a death tax roundtable in my district, in Omaha, Nebraska, and we had people from all sectors: From the accounting field; from the small business area; from the estate tax area; and financial planning. We listened to a lot of the stories they had experienced personally, and we had one individual who shared a good comment. Doug Kulak from Omaha said: "Jon, I can prove two things to you. I can prove that Uncle Sam is not a blood relative; and second, I can prove that Uncle Sam squanders his inheritance." And I thought that that comment rang true in terms of what we are looking at today, a truly bipartisan group of people. You have never seen as many witnesses from both sides want to testify about an issue that is onerous; that is taking capital formation away; taking away the thriving opportunity to start and to continue a business.

So, Mr. Chairman, I really believe we have an issue here that cuts across young, old, rich, poor, black, white, and that we can work together in a bipartisan fashion. More than 70 percent of family farms do not make it to the second generation because of the death tax. As a matter of fact, 87 percent do not make it to the third generation. By confiscating between 37 and 55 percent of a family's aftertax savings, the estate tax, which I like to call the death tax, punishes life-long habits of thrift, discourages entrepreneurship and capital formation, penalizes hard-working families, and has an enormous negative effect on other tax revenues.

This past year, 1 year ago last week, I lost my father, who died unexpectedly of cancer. I have seen what my mother has gone through in terms of preparing the estate, going through all of the various tax and accounting and legal situations, and she spent upward in the neighborhood of \$40,000 to \$50,000 in just preparation and getting ready to go through the whole process. I have seen a lady who was not used to this whole process, who spent her life being a housewife, a farm wife, and all of this has gone on for the Federal Government to bring in 1 percent. One percent of the Federal Treasury comes in from death taxes. Out of a \$1.5 trillion budget, we are talking about \$12 to \$15 billion. And I have seen some studies where it showed that if you took the amount of money that was spent in second-to-die life insurance policies, which I made a living in, and attorney's fees, accountants fees, if you took all of the fees and added them up and allowed the individual to save that money and to invest it, to put it back into their business, to create jobs and opportunities, you would see more money generated from the income taxes and from Social Security taxes and the other areas for the Federal Government that would far outweigh the amount of money that was collected from the death tax alone.

So, we have an issue here that I believe we can work together in a bipartisan fashion and achieve some kind of incremental reform. Now, I support the Hulshof-Crane bill; I support the Cox bill. But I also realize that the President isn't willing to go as far as we would all like to go. Now, we have had an opportunity to work with Erskine Bowles on the issue, and I applaud his leadership in starting to make some incremental reform in this area. But we need to go a lot further than the President has started. I believe an incremental form of raising the unified credit, from \$600,000 upward in the neighborhood of \$1 million; indexing it to inflation. As a matter of fact, if it had been indexed to inflation, currently, it would be at \$830,000 today.

Second, I would agree with Ms. Dunn that we need to create an exemption for the family owned business. We also need to give some meaningful relief to family farms, ranches, and family owned businesses. Last, I believe we need to begin a reduction, a slight reduction, over the 55 percent, bring it down gradually over time: 55 to 54 to 53. Make some small steps in this area if we cannot go with a full repeal this year.

I have a family friend out in western Nebraska, in Max, Nebraska, in Congressman Barrett's district. They were telling me about an issue where they had three siblings, four siblings in the family. Only one of them farmed. And so, therefore, they did not buy a large enough life insurance policy to be able to keep the one individual farming. They are struggling. They do not want to sell the farm. Yet, that happens every day in America, whether it is a small business or whether it is a family farm.

Mr. Chairman, this is an issue we can agree on; we can work together on, and I applaud your leadership, and hopefully, we can get something passed in the 105th Congress.

[The prepared statement follows:]

Statement of Hon. Jon Christensen, a Representative in Congress from the State of Nebraska

Mr. Chairman, I want to thank you and my other colleagues of the Ways and Means Committee for this opportunity to testify on the savings and investment provisions in the Administration's budget. I want to focus in particular on the estate tax.

The estate or death tax is killing family farms and small businesses. Today, more than 70 percent of all family farms and businesses do not survive through the second generation and 87 percent don't make it to a third generation. How sad. According to the National Federation of Independent Business (NFIB), 90 percent of small businesses which fail after the death of their founder are literally torn apart because the inheritance tax burden falls at a difficult time of transition. By confiscating between 37 percent and 55 percent of a family's after-tax savings, the estate tax punishes lifelong habits of thrift, discourages entrepreneurship and capital formation, penalizes hard-working families, and has an enormous negative effect on other tax revenues. Since the \$600,000 unified credit, enacted in 1981, is not indexed for inflation, it is worth only about \$377,000 in 1981 dollars. Every year the death tax brings more and more family farms and small businesses under its death sentence.

I have witnessed how the estate tax can kill a family farm. In Max, Nebraska, a strong community in Congressman Bill Barrett's district, the Gardner family lives on a modest plot of land. They raise some cattle and grow wheat, corn and alfalfa. The land that the Gardners live on once belonged to Mr. Gardner's father who passed away two years ago. Before the elder Gardner passed away, he planned for his death. The Gardner family employed an attorney, an accountant, and a financial planner to assist them in their estate tax planning. They did everything that the lawyers and accountants told them to do and yet they still might lose their farm.

Since the elder Gardner deeded his farm to his four children, and only one child and his family work on the farm, it has placed the other three siblings in an awkward situation. The Gardners did not purchase enough life insurance on their father, and when he died, there was not enough money to pay off the three siblings. If the siblings sell their land to the brother and his family, who work on the farm, they will pay exorbitant amounts in capital gains taxes. The son and his family who work on the farm are forced to lease the land from the other three siblings who do not work on the farm, making it nearly impossible to even keep up with the bills.

The Gardners would be better off if they sold their whole farm to the highest bidder. They have land, cattle, and machinery worth about \$1.8 million. But, the Gardner family is having a tough time making ends meet. I have asked Phyllis Gardner why they don't sell the farm. She, like almost every farmer and rancher I have ever known, is committed to keeping her family farm going—even if that means barely staying afloat. The federal government is destroying American family farms, ranches and small businesses. What the Gardner family has spent a lifetime working for, the federal government wants to take away.

Many people assume that the estate tax, unlike the income tax, will affect them only if they have large estates. In a way, they are right. The estate tax won't directly hit you unless you have an estate with a taxable value of \$600,000 or more (including any taxable gifts you've made during your lifetime). But, these days owning a home, a modest investment portfolio, life insurance, retirement benefits, a family farm or business can easily knock you into the estate tax realm. In 1993, estates from \$10 million to \$20 million paid 18 percent in that year; those over \$20 million paid just 12.6 percent. However, more than half the government's total estate tax revenue came from estates of \$5 million or less.

Others believe that the estate tax law won't affect them because they are leaving all of their property to their spouses. The tax law provides an unlimited marital deduction that allows you to leave all of your property to your surviving spouse free of federal estate tax. However, many people die without a surviving spouse. What happens if your surviving spouse dies, or if your spouse dies before you? The use of the marital deduction does not eliminate estate tax, it simply defers it until the surviving spouse dies.

The estate tax accounts for roughly 1 percent of the federal government's tax receipts a year, but eats up 8 percent of Americans' savings each year. That's \$15 billion that could be invested in expanding the economy. If the estate tax had been abolished in 1971, our national stock of savings would have been \$399 billion larger in 1991, the gross domestic product would have been \$46 billion higher and we would have 262,000 more jobs.

I support a full repeal of the federal estate tax and am a cosponsor of bills introduced by my good friends Rep. Crane, Hulshof, and Cox. However, I understand that not everyone agrees with me. To get meaningful tax relief passed by Congress and signed by President Clinton, we need to make incremental reforms. I believe that we need to do three fundamental things in reforming the estate tax. First, I believe we need to increase the unified credit and tie it to inflation. Currently, the estate tax credit is at \$600,000. Had it been indexed in 1981, it would be worth around \$830,000 today. Second, I believe we need to create a family-owned business exclusion to the federal estate tax. Last, I think we need to look at an across-the-board reduction in the statutory estate and gift tax rate—a rate that reaches as high as 55 percent.

Although the Administration's budget proposal provides estate tax relief, we need to take an ax to the estate tax and the Administration has handed us a butter knife. Under current law, estate tax attributable to certain interests in closely held businesses may be paid in installments over a 14-year period. A special four-percent interest rate is provided for the tax deferred on the first \$1 million. The regular IRS rate on tax underpayments applies to values over \$1 million. A special estate tax lien applies to property on which the tax is deferred during the installment payment period. Interest paid on the deferred estate tax is allowed as a deduction against either the estate tax or the estate's income tax deduction. The administration's proposal would increase the cap on interest rates so that it applies to the tax deferred on the first \$2.5 million of value of the closely held business. The current 4 percent rate would be reduced to 2 percent, and the rate on values over \$2.5 million would be reduced to 45 percent of the usual IRS rate on tax underpayments. The interest paid on deferred estate tax would *not* be deductible for estate or income tax purposes. While I applaud the Administration's first step, I believe that we can go much, much further in providing meaningful estate tax relief.

In closing, I want to again thank you, Chairman Archer, and my colleagues on the Ways and Means Committee for the opportunity to testify before you today. The death tax is a disincentive for owners of family businesses and farms to expand

their operation and create jobs. Repealing it would eliminate 82 pages of the tax code and 300 pages of regulations that American taxpayers are forced to follow. I believe as a society we are already taxed too much. We pay property taxes, sales taxes, gasoline taxes, and income taxes, just to name a few. The federal death tax is a tax on money that has been taxed at least once, if not more. Repealing or modifying the death tax will help ensure economic fairness for all American families and businesses, as well as provide economic growth and prosperity for the nation as whole.

Thank you.

Chairman ARCHER. Thank you, Mr. Christensen.

My compliments to each of you for, I think, excellent presentations.

Does any Member of the Committee wish to inquire?

Mr. RANGEL. I guess my question to Ms. Dunn will be a very general question that everyone does not have to answer: What estimate do you have of the capital gains tax cuts that would please you—over a long period of time.

Ms. DUNN. We do not have an estimate yet on our bill, but our bill includes some facets of other bills, and it could be as high as \$60 billion over 10 years.

Mr. RANGEL. In estimates of many capital gains proposals, there is an increase in revenues in the early years and then, a large decrease in revenue in the later years. Proponents of cutting capital gains taxes complain about the method of calculating revenue losses. They claim you do not actually lose revenue. Notwithstanding that point of view, we must use the methods of CBO and the White House. So, how do you explain when people say that is a great idea, how you are going to pay for it? How do you respond to that? Since I have been here, the biggest argument against capital gains tax cuts that have been demanded has been the shortfall in revenue.

Ms. DUNN. Mr. Rangel, I do believe that static scoring is not an interpretation of behavior, and I think that is a shortfall in our scoring system. I would like to see our bill scored under dynamic scoring, but that is not an opportunity for us right now, and that is why I gave you the number I did, because that is under static scoring, as close as we can come together with the facets of our bill, which, as I said, has not been scored since we introduced it just a week or so ago.

My belief is based on history. In the twenties and the sixties and the eighties, consistently, we saw that when people were allowed to have some kind of rate reduction in capital gains, this unlocked assets. It caused and will cause a larger degree of trading of these assets. Somebody sells a home; that commission is given to a realtor. The realtor takes it to a local hardware store; the hardware buyer buys groceries and so forth, and that creates an increase in revenue.

Mr. RANGEL. I do not want to debate the merits. If you and I agree that dynamic scoring is not available to you and it is not available to me, then we put that issue aside. I would not want to discuss the merits regarding what positive impact it would have on the economy because you can line up the economists and get no consensus on that subject.

But when it reaches the point that we have got to make certain that we come up with a revenue-neutral bill, that is when we look around and wonder, Who “behind the tree” are we going to tax in order to pay for a capital gains tax cut? Every time we talk this way, some program designed to give assistance to the poor not only comes up on the radar screen but stays there. Other ways of paying for it come and go. The President has a whole lot of revenue raisers that will not stand the light of day in this Committee. But he has proposed them as revenue raisers.

So, I guess we do not have an answer today. Although I want so badly to work with both sides, it just seems to me that we cannot even consider the merits seriously until we find a way to raise the money so we end up with a revenue-neutral bill.

Ms. DUNN. Mr. Rangel, I appreciate your point of view, and I agree with you. We do need to come up with the revenues. And in a broad context, I would say that that is where spending cuts come from. But in addition to that, as I say, there is revenue that is actually produced from the particular tax relief package that is contained entitled “capital gains.”

Chairman ARCHER. Does any other Member of the Committee wish to inquire?

Mr. Becerra.

Mr. BECERRA. Mr. Chairman, thank you; I will be brief. I just have one question, and I offer it up to anyone on the panel. If we get into the discussion of dynamic scoring and what we consider investments that pay off more than they will cost us, I was wondering if any of you would be willing to comment on the whole issue of programs such as Head Start and prenatal care. We have been told in the past that if we invest \$1 in Head Start, we can prevent a child from becoming an at-risk youth and ultimately an adult offender; that individual who may go on to college and be more productive than just a high school graduate.

We know that a \$1 spent on prenatal care probably saves you \$3 in after-birth costs of infants who are born with some abnormality or problem that could be prevented. I know we just had a debate last week on the whole issue of drugs and Mexico certification, and I saw some studies that showed that for every \$1 we invest in preventing drug use and providing for drug rehab, we save \$11 necessary to do drug interdiction and \$23 to do drug eradication in foreign countries.

Your thoughts on if we were to ever go toward some form of dynamic scoring, how we should score programs like Head Start or prenatal care.

Mr. CHRISTENSEN. Mr. Becerra, I think what you have touched on is a much deeper issue, and the issue goes to the fundamental question of what is the proper role of the Federal Government rather than the dynamic scoring issue.

Mr. BECERRA. But, then, no comment in terms of the dollars or the investments?

Mr. NEAL. I agree with you, Mr. Becerra, and believe that having children who can read and write is real national defense as well as what we do around here every day in providing for what we commonly refer to as the national defense.

Mr. McCRERY. I do not disagree with Mr. Neal entirely. There are all kinds of investments that we make as individuals and that we make as a government. I think, though, to be able to predict a return on the investment gets more difficult as you get into the programs such as those you mentioned. But certainly, some of those could be considered investments. But when you have to score it, it gets very difficult.

Ms. DUNN. Mr. Becerra, I would just say that I know there are groups right now who are putting together plans for dynamic scoring. I think it would be very interesting for all of us to hear from them. I do not know the answer to your question. I would like to know the answer. When I think about what could pay for programs like what we have advocated today, though, there are certainly areas that do not have to do with Head Start or other areas that many of us do support that could be cut, and I would offer up one, the Government Printing Office, as an example of something that we have barely touched, and privatization, securing for the Government and the GPO the ability to contract out, that there is a cut just minimally at \$1.5 billion over the next 5 years is how that has been scored.

But certainly, when you come to dynamic scoring, you have to look at the change in behavior, and so, what you asked about Head Start as an example is going to depend on the welfare system and how well our changes are enacted and accepted there. But I simply say that behavioral scoring is very important. I realize we have to have a mix of the two, because you do not want to get out there too far, but people are putting together a plan, and it would be interesting at least for me to hear from those folks.

Mr. BECERRA. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Portman.

Mr. PORTMAN. A brief question for the panel on the estate tax issue. I appreciate the testimony from all my colleagues and sympathize with your position on the estate tax. I think, as Mr. Christensen said, it is more likely that we can reform it this year than repeal it, and I think some of these proposals make a lot of sense.

My concern is simply on the issue of complexity and how you go about defining in particular family businesses and family farms. I have always believed that that would not only cause the IRS a lot of problems, and we are all finding out about the IRS' inability to administer our current code, but also our taxpayers. And it would, perhaps, Mr. Christensen, put a lot more money in the pockets of those tax planners you talked about and the lawyers and accountants and so on trying to figure out how to define your business in that way and to meet those criteria.

Mr. McCrery, you had a thoughtful statement this morning, and I know you have thought a lot about this issue, so I will ask you: Why not—and perhaps this is simply a revenue issue—why not simply raise the exemption, as you have suggested, to \$1 million or even \$1.5 million, change the provisions of the exemption to a real exemption so that the tax rate that applies is the lowest rate after that amount, and index it to inflation to be able to catch up to what would now be about an \$830,000 exemption had it been in-

dexed for all Americans and not to try to define and to carve out these special categories within the tax law?

Mr. McCRERY. Well, I think the families that are being hurt the most by this are the ones that have invested in businesses, that have built their family businesses over generations, and some of the data we have seen recently talked about by Ms. Dunn and Mr. Christensen indicate that it is very, very difficult these days for those small businesses to survive generational transfer because of the estate tax. In a recent survey, the number one reason for small businesses and family farms ceasing to exist was the estate tax. That is why I have chosen to target those family businesses, family farms for relief. I think as Ms. Dunn and Mr. Christensen said, I, too, am for the abolition of the estate tax, but that is just not a realistic goal, I think, in the short term.

So, when we start talking about limited revenue that we have for tax cuts, I wanted to target a proposal that would have minimal loss of revenue and do the most good: Get the most bang for the buck. And I think we do that when we target family businesses, family farms, family ranches for relief.

Mr. PORTMAN. And how do you respond to the concern that we may have difficulty defining those entities and that there may be the ability for taxpayers to shift assets around or even change forms of business to be able to qualify? And how can we avoid those problems?

Mr. McCRERY. You cannot avoid them.

Mr. PORTMAN. Is there a simple way to define what is a closely held or family business?

Mr. McCRERY. We have chosen the simplest way, which is not simple, and it is subject to interpretation. However, in the legislation that we are writing for introduction soon, we do expand the definition to bring in the greatest number of entities that one would normally think of as a family business. So, you are never going to be able to have a definition that is not subject to interpretation by the IRS or by us. But that is no reason not to endeavor to give relief to those folks.

Mr. PORTMAN. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Jefferson.

Mr. JEFFERSON. I have an ever-so-brief question. I am trying to see—Jim, is it fair to say, if you have read Jennifer's proposal on estate tax relief, that yours is less broad than her proposal? Or are they more similar than I read them? She talks about unified credit, targeted relief for family farms. It is a level of rate reduction. You are talking about raising the exclusion to \$1.5 million; you talk about a real unified rate. The first dollar over \$600,000 you would tax at 18 percent. And I think another provision—I have kind of forgotten what it was.

Mr. McCRERY. Perhaps you would be interested in the historic property provision, Mr. Jefferson.

Mr. JEFFERSON. I'm sorry?

Mr. McCRERY. Perhaps you would be interested in the historic property provision.

Mr. JEFFERSON. Yes, sir; that would be appealing to me, sir.

But what is the difference, sir, between what you are proposing and what Jennifer is proposing on estate tax relief?

Mr. MCCRERY. Actually, Ms. Dunn and I worked together for a long time developing a new bill, and we ended up deciding to introduce two different bills. The primary difference is the approach on estate tax relief. She chooses to reduce rates from the top down, basically; I choose to reduce rates from the bottom up. So, I target more relief to the smaller businesses, the smaller estates than she has chosen to in her bill. I do not disagree with her approach. I would love to do that. I just think the people in this country who are getting hurt most by the estate tax are your smaller businesses, smaller farms, and I want to target relief as much as I can to those folks with the limited revenue that we are going to have available to use in any tax cut portion of reconciliation.

Mr. JEFFERSON. Consequently, yours is less expensive in that area than hers is. It is more targeted and less expensive.

Mr. MCCRERY. Yes.

Ms. DUNN. Mr. Jefferson, let me just add that mine is similar to Mr. McCrery's, but we have a broader approach in that we also do the rate reduction. And my thought, even though we haven't filed the bill yet, is that we would, at some point in the near future, begin a rate reduction of 1, 2, or 3 percent a year on the top rate. But responding to Mr. Portman, too, I would just say there are lots of ways to go about this, and one would make estate taxes comparable to regular income taxes. I think that could simplify the system, if you took away the entire rate that is currently in place on estates and make estates, inheritance, subject to regular income tax rates.

Chairman ARCHER. Mr. Jefferson, have you concluded your inquiry?

Are there any other Members who wish to inquire?

If not, the Chair would just conclude by making a couple of small requests: Mr. McCrery, do you have a revenue estimate on your proposal?

Mr. MCCRERY. Not yet, Mr. Chairman. We are having legislation written as we speak.

Chairman ARCHER. OK.

Mr. MCCRERY. We will get that to the Joint Committee on Printing as soon as possible.

Chairman ARCHER. Mr. Neal, do you have—

Mr. NEAL. We do not have a final one.

Chairman ARCHER. You do not either.

Ms. Dunn mentioned her revenue—

Mr. CHRISTENSEN. No, Mr. Chairman, we are waiting.

Mr. MCCRERY. Mr. Chairman.

Chairman ARCHER. Yes.

Mr. MCCRERY. The bill we had introduced last year was \$6 billion over the 5-year budget window. We expect this year's bill to be very close to that.

Chairman ARCHER. OK; thank you very much and thank you again for your testimony.

Our next panel is a number of our own colleagues from other Committees, and if you will take your seat at the witness table: Hon. David Dreier, Christopher Cox, Collin Peterson, Peter Deutsch, Earl Pomeroy, and Karen McCarthy.

Gentlemen and Ms. McCarthy, a warm welcome to each of you. Mr. Dreier, if you would be our leadoff witness for this panel, we would welcome you, and you may proceed.

**STATEMENT OF HON. DAVID DREIER, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF CALIFORNIA**

Mr. DREIER. Thank you very much, Mr. Chairman, and let me say I am somewhat embarrassed to be here before you advocating any tax on capital whatsoever. The fact of the matter is that you and I share a view that there should not be a tax on capital, and I think it is very important to recognize that what we are proposing is, I believe, a very good compromise position.

I have talked at length with you, with Charlie Rangel, with Mr. Crane, other Members of this Committee, Mr. Jefferson just yesterday, on this issue, and I think it is a very, very important one. On the opening day of the 105th Congress, your Committee Member Phil English and I joined with my colleague, the former Chairman of the Ways and Means Committee of the Missouri State Legislature, Congresswoman Karen McCarthy, Jim Moran of Virginia, and Ralph Hall of Texas—more Democrats than Republicans on the opening day—and we are joined today by Peter Deutsch from Florida, another Democrat, who has joined along with 90 Democrats and Republicans in cosponsoring the bill we introduced on the opening day, which takes the top rate on capital gains from 28 percent to 14 percent and indexes.

Now, I have been listening to the testimony of the other panel, and I think that some important things have been said which I believe need to be underscored, and I would like to try and maybe answer some of the questions that were posed by Members of the Committee as we proceed.

I agree with Jennifer Dunn that the reduction of that rate on capital gains would do more than almost anything to boost the economy. There are three things we have been focusing on in a bipartisan way in this Congress. They include trying to balance the budget, increasing the take-home pay of working Americans, and spurring economic growth. And as we look at halving the capital gains tax rate, it seems to me we can successfully address every single one of them.

This argument that has been made by so many, and I think Charlie Rangel very appropriately asked about the cost factor, is one that needs to come forward, but we also have to look at the benefit that is going to be accrued to the economy. We are at a point where I think we should recognize that the economic growth we are enjoying today is not going to continue ad infinitum, and I think a capital gains tax rate reduction is going to be pivotal to our attempt to ensure that we do not move into recession.

We all know the chairman of the Federal Reserve has made a very strong statement on the issue of capital gains, and so, I think a capital gains tax rate reduction would be a federally friendly reduction, which I think is something that also needs to be addressed.

And also, I am gratified by the fact that we very rarely hear the argument that was so prevalent during the last several years, that being that reducing the top rate on capital gains would be nothing

but a tax cut for the rich. The arguments that were made by the last panel, I think, very appropriately put forward the fact that 40 percent of capital gains taxes are realized by people who earn less than \$50,000 a year. Peter Deutsch, I suspect, might mention something that he said to me the other day: 63 million American families have mutual funds today. So, this is something that I believe is very important for us.

To specifically get into Charlie's question on the cost factor, we have scored with CBO and Joint Tax a \$44 billion cost over that 5-year period, although, as I just said, I think it is important to recognize that we should look at the benefits. This "cost" would be less than half of the proposal in the President's cost, and I think if you look at more realistic scoring, we several years ago formed what I call the Zero Capital Gains Tax Caucus, bipartisan, bicameral, and I think that over a 7-year period, if we look at this, we could have a gain of \$211 billion in revenues to the Treasury.

Mr. Rangel, you and I have often talked with our mutual friend Jude Wanninski on this—yes, well—[Laughter.]

Mr. DREIER. The fact is that we do both talk to him, and I think that it is no secret that we do, and there is going to be a real benefit. Frankly, Bill Jefferson, I know, has raised this. Xavier Becerra has raised this; you have raised this, the need to address the challenges that exist in the inner city and other areas. I believe that what we are proposing would go a long way toward getting the needed capital into the areas where you and I are very, very concerned, and I hope very much that the Committee will proceed with this and, again, recognizing that we have broad, bipartisan support.

The President is great in focusing on the issue of capital gains reduction in the area of human capital, his education area. But we also have to look at the other half of the equation, and that is physical capital that goes along with it, and that is why an across-the-board proposal, I think, would be very beneficial.

Thank you very much for inviting me to be here, Mr. Chairman. I am used to looking at you in the Rules Committee, and so, it is nice to have a chance to come before you and all of the other distinguished members of this panel.

[The prepared statement follows:]

Statement of Hon. David Dreier, A Representative in Congress from the State of California

Mr. Chairman, Members of the Committee, thank you for holding this important hearing on the tax proposals in President Clinton's fiscal year 1998 budget submission. I am grateful for the opportunity to take a few minutes to discuss the President's proposal for a very limited modification in the capital gains tax, and my support for a major reduction in this anti-investment, anti-growth and anti-savings tax.

I believe that we must judge any tax proposal on its ability to address two of our most pressing economic needs—increasing real economic growth and raising the wages of working Americans. Cutting the capital gains tax rate in half offers one of the most reliable, fair and fiscally responsible methods of achieving those two goals.

On the first day of the 105th Congress I joined with a bipartisan group of our colleagues to introduce H.R. 14, legislation to cut the maximum tax rate on capital gains to 14 percent, reduce the lower tax rate from 15 percent to 7.5 percent, and end the taxation of capital gains due solely to inflation. Today, over 90 of our colleagues have sponsored this bipartisan bill.

A capital gains tax cut should not be a partisan issue. Reducing the tax on investment puts good public policy ahead of politics. Promoting investment in new fac-

tories, equipment, machine tools and technologies will benefit working people of every income level. Cutting the capital gains tax rewards homeowners, farmers, small business people, entrepreneurs and mutual fund holders, not Democrats or Republicans.

Mr. Chairman, balancing the federal budget by 2002 is a goal I share, and I know you share, with President Clinton and the majority in Congress. This is clearly a top fiscal priority. At the same time, the balanced budget passed by Congress the past two years, as well as the President's FY 1998 budget proposal, illustrates the clear fact that tax cuts and a balanced budget are not incompatible. The President's budget includes nearly \$100 billion in tax cuts. Although I prefer a more aggressive tax cutting agenda, I believe that we can do much to improve our economy, raise living standards, and help balance the budget with tax reductions totaling \$100 billion over five years.

A broad-based capital gains tax cut such as that embodied in H.R. 14 would account for less than half of the President's \$100 billion tax cut target. Most important, it is a tax cut that is likely to help us attain a balanced budget by 2002. Even if Congress and the President agree on a bipartisan balanced budget this year, a recession between now and 2002 will derail the process. A capital gains tax cut is the best antidote to a balanced budget-killing recession.

Mr. Chairman, fiscal policy, budget policy, and tax cuts do not occur in a vacuum. There is no question that the Federal Reserve Board's interest rate policy can make or break the success of any balanced budget plan that cuts taxes. If the Fed believes that a given tax policy raises the prospect of inflation or fails to increase real economic productivity, it is possible that monetary policy will not be supportive. Therefore, I was very encouraged by the comments of Federal Reserve Board Chairman Alan Greenspan before the Senate Banking Committee last month. He said:

I think while all taxes impede economic growth to one extent or another, the capital gains tax, in my judgment, is at the far end of the scale. And so, I argued that the appropriate capital gains tax rate was zero. And short of that, any cuts and especially indexing would, in my judgment, be an act that would be appropriate policy for this Congress.

Mr. Chairman, I know you share the view of Chairman Greenspan that the best capital gains tax rate for the overall health of the economy would be zero. I share that view, and I organized the bipartisan, bicameral Zero Capital Gains Tax Caucus in the 103rd Congress to raise that issue. However, given that the President has not proposed reducing the current tax rate, I believe that totally eliminating this anti-entrepreneur tax is not politically feasible. However, we can split the difference. Cut the 28 percent rate in half, to 14 percent.

The capital gains tax has become a political football because of charges that it is a tax cut for the rich. While I don't think punitive, politically motivated, class-warfare goals ought to determine our tax policy, I would argue that the charge is simply incorrect. As The New York Times detailed in a major report in December, the capital gains tax "is becoming largely academic to the nation's wealthiest taxpayers." That report quoted David Bradford, an economist at Princeton University, expressing a view too many families on Main Street USA share. "The Government can adopt rule after rule after rule—but the people who will get stuck paying capital gains taxes will be the ordinary investors," said Bradford.

Mr. Chairman, forty percent of annual capital gains are realized by people with incomes of less than \$50,000. Regular people—farmers, small businessmen, families with some savings in mutual funds, small investors with rental property—are the ones who face the bite of the capital gains tax. They are left out in the cold by the President's very narrow capital gains tax proposal that places good politics over sound economic policy by selectively targeting one type of investment.

Even though many middle income Americans will directly benefit from a broad-based reduction in the capital gains tax, we must move beyond looking at who gets the tax cut and focus of the economic benefits of any tax change. At the very top of our priority list must be ensuring that we, as a nation, make the investments needed to help working families raise their living standards.

While I am not convinced that President Clinton's education tax credits will work, I cannot argue with his goal of using the tax code to promote investments to raise the skill-level of new workers and help current workers learn new skills. Economists would call that investment in human capital. His proposals deserve a serious look.

At the same time, investment in the skills of working people only addresses half the equation. It is also critical that we encourage the private sector to invest in the machines, technology and tools that will raise the productivity of American workers, and thus their wages. Cutting the capital gains tax rate in half will do just that. Economists call this pro-worker tax reform investment in physical capital.

Cutting the tax rate on capital gains will lower the cost of investing in the kind of tools and technology that makes American workers the most productive in the world—and that means higher pay. A 1993 study by the Institute for Policy Innovation predicted that cutting the capital gains tax rate to 15 percent and indexing the rate to inflation would boost the wages of the average American worker by \$1,500 over seven years. Those are gains that don't expire at some future date like some self-advertised pro-family tax cuts. Of course, the tax cut will also bring immediate relief to small investors, small business owners, family farmers, homeowners, and the elderly.

Mr. Chairman, there is much to be done to get our economic house in order. We must balance the budget because mounting debt saps life from the productive sectors of our economy and strangles resources needed for important government programs. We must also help the working families that have seen their incomes stagnate as they try to prepare their children to get good 21st century jobs. While the President is proposing tax credits to help with college costs—a commendable goal—we also owe those working families a broad-based capital gains tax cut to ensure that plentiful technology, tools and high-wage jobs are available in coming years.

Thank you again for giving me the opportunity to testify this morning.

Chairman ARCHER. Thank you, Mr. Dreier.

Mr. Deutsch, since your name has been mentioned in Mr. Drier's testimony, we would be pleased to recognize you. Welcome to the Ways and Means Committee. You may proceed.

**STATEMENT OF PETER DEUTSCH, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF FLORIDA**

Mr. DEUTSCH. Thank you, Mr. Chairman. I appreciate it. I'm glad you remembered what we talked about, which is a good sign.

We are clearly living through an incredible age in American history and in world history, in a sense, a blessed age to be living through, a renaissance of the American economy. The American economy has leapfrogged other economies in the world, and we literally, whether we acknowledge it or not, are in a new age in terms of economics. We are an economic powerhouse. We have transcended the age, and we are in an information age, and where it is going to end, we do not know.

And access to capital is critical in this age. We have the ability, as the U.S. Congress, to grow the economy more, and we have the ability on the capital gains issue to do that specifically.

I am going to focus a little bit, though, on the fact, and I think it is appropriate to talk a little bit about how this issue has come to us today in the present form that it is, that capital gains cuts too often have been viewed, I think, in a demagog way really by my own party, that a capital gains cut is a cut that just benefits the wealthy, and that's why some people, on occasion, have spoken against it.

I think that that attitude is changing and is also just flat wrong. Obviously, growth in the economy affects everyone directly, but there are just some fascinating things that have happened in the economy. First, just the statistics themselves, I think, are important. Another number, even below the \$50,000 threshold, in 1993, 37 percent of U.S. taxpayers reporting capital gains and income of \$30,000 or less. But the phenomenon of mutual funds and the fact of the investments of middle-class Americans in mutual funds is a phenomenon that really did not exist 10 years ago. Sixty-three million American households have investments in mutual funds. It is

an incredible statistic, an absolutely incredible statistic. A majority of these households have incomes ranging from \$35,000 to \$75,000.

The growth has been unbelievable: 20 percent growth since 1994, 800 percent growth since 1990. It is a phenomenon that if we do not acknowledge as policymakers, I think we are missing something very important. Again, I am going to speak to my own party and really to the President: I think not to support across-the-board capital gains cuts misses this entire group of people; essentially misses the middle class of America. If we are looking for a middle-class tax break in the United States of America in 1997, what we really ought to be talking about is capital gains cuts. If you tie it into the phenomenon of mutual funds, there are literally hundreds of billions of dollars, in a sense, of phantom income that people are paying tax on, and the phantom income I am describing, because the typical situation, where it is a mutual fund that is a retirement fund, but mostly middle-class people, and you can look to yourself and your friends whom you know and your constituents. What are they doing with their capital? For most Americans, where are they putting their capital that they are earning on a daily basis, a monthly basis? An incredible percentage, 90 percent of capital, in the last several years has been going into this phenomenon.

And the phantom income, in a sense, is people are getting taxed on the appreciated gains, but generally, they are not selling the mutual fund in terms of paying that tax. That is coming out of their disposable income. And it is a phenomenon that people are seeing. And I think as an institution, this Congress is missing the boat. It is missing a phenomenon in the American economy not to be changing the capital gains tax for the broad-based economic reasons that we are talking about, to grow the economy.

But also, if we are talking about middle-class tax cuts, for 63 million American households, the numbers speak for themselves. If we want to give people more money back in their pockets; if we want to help the hard-working people who are the core of our economy and the core of our society, then, that is what we need to do, and I urge this Committee to take that action, and I urge my colleagues in the Congress in general to support an across-the-board capital gains cut.

Thank you, Mr. Chairman.

[The prepared statement follows:]

**Statement of Representative Peter Deutsch, a Representative in Congress
from the State of Florida**

Mr. Chairman, Members of the Committee, thank you for this opportunity to discuss with you what I see as perhaps the most important issue in U.S. tax policy—the capital gains tax. President Clinton's budget calls for a targeted modification to the capital gains tax. I would argue that our economy would be served better by a comprehensive capital gains reduction. This reform would be good for the American people, good for the national economy, and can be accomplished in the context of a balanced budget.

I have worked in Congress to eliminate the federal deficit, balance the budget, and promote an equitable economic package for my constituents in South Florida and the American people. While we have made great strides in reducing the deficit and committing in principle to balance the budget by 2002, we have failed to address capital gains reform. Reducing the tax can only benefit the economy and the public. Such a move will encourage savings and investment and is necessary if we as a nation are going to compete globally and have a healthy economy.

What many fail to see is that a capital gains tax reduction would benefit all Americans. In fact, 40 percent of capital gains are realized by individuals with in-

comes less than \$50,000. Now more than ever, capital gains is an issue that crosses socioeconomic borders. Consider the massive movement toward mutual funds which has become the preferred savings and investment vehicle for more and more Americans. Today, an estimated 63 million Americans and 37 million households are invested in mutual funds. That figure represents a 20 percent growth since 1994 and an 800 percent jump since 1980. The majority of these households have incomes ranging from \$35,000–\$75,000—a true example of how middle income America is now affected by the capital gains tax. Eighty-four percent of mutual fund investors are primarily investing for retirement. Middle aged Americans comprise the largest bloc of mutual fund investors as 35–64 year olds own 77 percent of the mutuals. With the explosion of mutual funds among middle class families, Congress should encourage more savings and investment by reforming the capital gains tax.

The appropriate way to meet the needs of a growing market and the public's changing attitude towards investment is to incorporate real capital gains relief into any economic package that we support. I am a cosponsor of H.R. 14—The Capital Gains Tax Reduction Act of 1997—a bipartisan bill which is cosponsored by over 90 of my colleagues. H.R. 14 would cut the maximum tax rate on capital gains to 14 percent, reduce the lower rate to 7.5 percent, and index for inflation. This legislation represents a strong, comprehensive effort to attack an issue that threatens to hinder the potential growth of the U.S. economy.

It is time that members of Congress get serious about capital gains tax reform—Republicans and Democrats alike. Reducing the tax on capital gains should not be a partisan issue or used as a political tool. As a Democrat who supports a reduction in the capital gains tax, I am working with my Democrat colleagues to forge a consensus on this issue. Some of my colleagues believe that a capital gains tax reduction would solely benefit the rich. It is apparent that is simply not the case. I am currently spearheading an effort to form a consensus within the Democratic Caucus by openly calling for my Democrat colleagues and President Clinton to address capital gains relief within the context of a balanced budget.

Mr. Chairman, thank you again for this opportunity. I look forward to continuing our efforts to encourage more savings and investment for more Americans.

Chairman ARCHER. Thank you, Mr. Deutsch.

The Chair next recognizes Congresswoman Karen McCarthy, who is also a cosponsor of H.R. 14.

Ms. McCarthy, welcome to the Ways and Means Committee.

**STATEMENT OF HON. KAREN MCCARTHY, A REPRESENTATIVE
IN CONGRESS FROM THE STATE OF MISSOURI**

Ms. MCCARTHY. Mr. Chairman, I thank you. I am very honored to be here on behalf of H.R. 14 to express my support in this bipartisan effort. It is critical, as you have heard from the numerous Members who have already testified, that we in the 105th Congress address tax relief. This particular legislation will help homeowners, working families, and will also help the private sector promote job growth.

I wanted to speak very briefly about what that will mean for the small businesses in my district and around the Nation, because they are very concerned about their businesses as it relates to capital gains. A survey of the 3,000-plus members of the Greater Kansas City Chamber of Commerce reflects that a primary concern of businessowners is the reduction of the capital gains tax rate. Under the status quo, financial resources are trapped and precluded from benefiting our economy as a whole.

In the metropolitan Kansas City area, which I represent, we know that a majority of the job growth will come from existing firms. So, with the relief that is provided in H.R. 14, job growth will be enhanced, not prohibited. Mr. Chairman, whether the legis-

lative vehicle is H.R. 14 or one designed by your Committee in its wisdom, I believe we must address this issue, build on the bipartisan agreement we have in place through our President and our legislative leaders on both sides of the rotunda, and pass a capital gains tax reduction in the 105th Congress. Working men and women in my district and around the country would benefit from a meaningful capital gains tax reduction, because the investments, savings, and the economy would all gain from unleashing these captured resources.

You have my written testimony, Mr. Chairman. I very much appreciate the responsibility you have in moving this issue along, and I, therefore, would refer you to that and would be happy to answer any questions when time permits.

[The prepared statement follows:]

Statement of Hon. Karen McCarthy, a Representative in Congress from the State of Missouri

Mr. Chairman, Members of the Committee, thank you for holding this hearing on the President's tax proposals, and for allowing me to address the committee on this important subject. As many of my colleagues have testified, I also believe we should pass middle-class tax relief during the 105th Congress, especially for homeowners and working Americans. As an original cosponsor of HR 14, the Capital Gains Tax Reduction Act of 1997, I would like to note the bipartisan support that is building for this legislation. Our proposal will bring immediate relief to working families, small business owners, individual investors and seniors.

As we work to develop a balanced budget that is reasonable and fair to all Americans, we must ensure that we, as a nation, make the investments needed in human capital to help working families raise their standards of living. President Clinton proposed a capital gains exclusion on the sale of a principal residence, which will help homeowners, in addition to proposing much needed investments in education to grow the skill level of new workers while helping enhance the abilities of the current workforce.

These investments are an important step, but only address part of the equation. It is also critical that we encourage the private sector to invest in the physical capital of machines, technology and tools that will increase the productivity of American workers and our economy. H.R. 14, the Capital Gains Tax Reduction Act of 1997, cuts the top tax rate on capital gains from 28% to 14%, the lower tax rate from 15% to 7.5% and indexes assets to inflation. This will help homeowners and working families, but also help the private sector promote job growth. Many of the small business owners in my district and around the Nation are very concerned about their businesses as it relates to the capital gains tax rate. A survey of the 3,000 plus members of the Greater Kansas City Chamber of Commerce reflects that a primary concern of business owners is the reduction of the capital gains rate. Under the status quo, financial resources are trapped and precluded from benefiting our economy as a whole. In the metropolitan Kansas City area, we know that a majority of the job growth will come from existing firms. With the relief provided in H.R. 14, job growth will be enhanced and not inhibited.

The overall benefit of a capital gains rate reduction will be felt in each and every household which we are privileged to represent. An increasing number of Americans have become investors in mutual funds, stocks, bonds, and other securities. These individuals are trying to provide for a better future for themselves and their families. Even without extraordinary gain in the capital markets, they are trapped in their investments with the current tax structure. Looking a step further, one finds that our citizens are participating in pension plans which could benefit from the passage of H.R. 14.

It is time to move beyond politics and make the investments needed to raise the incomes of working families and ensure a growing economy. This year's important bipartisan agreement on priorities for the 105th Congress between President Clinton and congressional leaders included both education initiatives and tax relief. Whether the legislative vehicle is HR 14, or Mr. Matsui's HR 420, the Enterprise Capital Formation Act of 1997, of which I am also a cosponsor, we should build on that bipartisan agreement and pass a capital gains tax reduction in the 105th Congress. Working men and women in my district and around the country would benefit

from meaningful capital gains rate reduction because the investments, savings, and the economy would all gain from the unleashing of these captured resources.

Chairman ARCHER. Thank you very much, and I understand that you were Chairman of the Ways and Means Committee in the Missouri Legislature, so you can understand the responsibilities that go along with this.

Ms. MCCARTHY. I am very respectful and mindful of those responsibilities, Mr. Chairman, and I appreciate the task that you are about.

Chairman ARCHER. Thank you for your testimony.

Our next witness is Hon. Chris Cox of California. Welcome to the Committee. We are delighted to have you, and we will be pleased to receive your testimony.

**STATEMENT OF HON. CHRISTOPHER COX, A REPRESENTATIVE
IN CONGRESS FROM THE STATE OF CALIFORNIA**

Mr. Cox. Thank you, Mr. Chairman, and I, too, am a sponsor of H.R. 14 and any other legislation to the same effect. Often, and this morning is no exception, when we talk about reducing tax rates, we confuse the discussion with reducing tax revenues, and the question arises: How are you going to pay for it?

There are two problems with this. One is that the presumption that an adjustment in tax rates is going to cost revenue to the Treasury is often false, and second, the use of the personal pronoun "you" is ambiguous. When we ask the question, How are you going to pay for it, it is not clear who you is. I would suggest that we would be just as well advised to have the antecedent of you be the American people as the Government of the United States, because the Government will never be fiscally sound over the long term if the economy which supports it is not.

And so, if we have not figured out how the American people are going to pay for this, we have an even bigger problem than if we have not figured out how the government is going to pay for it. On the first point, on the false premise that reducing tax rates is going to lead inexorably to lower revenues to the Treasury, I would cite only our own experience with the Joint Committee on Taxation and with the estimates of past revenue legislation. We are talking this morning about capital gains, and it is a perfect example, probably the best example. You all know—and some of you served on this Committee in 1978 when this happened—that when STIGR was proposed, Joint Tax told us it was going to cost a bundle. It was going to cost a lot of money to reduce the capital gains tax rate by almost half, as we did in 1978.

But Joint Tax was wrong. It did not cost a bundle. In 1979 and 1980, revenues went up. Then, we heard testimony before this Committee that this was a one-time phenomenon; there was sort of a fire sale effect. Well, of course, with all of this pent-up, locked-up capital, you would get an immediate effect from reducing the rate of tax on capital gains, but it could not last. And yet, in 1981, when this Committee passed the Economic Recovery Tax Act, and Joint Tax told us that surely, reducing the rate further, from 28 percent down to 20 percent, phased in between 1981 and January

1, 1983, surely, that would really cost a bundle. And they were wrong again; it did not cost a bundle. It, in fact, raised a bundle. From the base year of 1978, when we started reducing the rate of tax on capital gains to 1986, the last year of sound tax policy on capital gains in this country, revenues to the Treasury did not go down as Joint Tax told us and as it was scored for budget purposes in this Congress. They went up over 500 percent. And just in case you wanted empirical data the other way, Congress tried the experiment in the opposite direction, and we jacked up the rate of tax on capital gains to its present level in 1986, and in the following year, revenues fell from \$50 to \$33 billion.

So, we ought not listen to a debate about static or dynamic modeling; we ought to stop the fraud. We ought to get accurate numbers. We are not using them. We live in a fantasy world here. And I raise the same point with respect to the estate tax, the death tax. It raises less than 1 percent of Federal revenues. And I make an impassioned plea: Please do not raise the exemption if you are interested in simplifying taxes because it does nothing to simplify taxes. In one fell swoop, with something that accounts presently for less than 1 percent of Federal revenues, you can eliminate over 80 pages of the Internal Revenue Code and over 200 pages of regulations.

You know that rich people do not pay this tax, or rarely do they pay it, because, like Jacqueline Kennedy Onassis, they can form a state-of-the-art trust to avoid it or avoid most of it. It is not even the small businesses and the family farms and the family ranches that we should be concerned most about. It is the low-wage workers at these businesses who pay a 100-percent tax rate when their jobs are destroyed, when the property, because this is essentially a property tax, must be liquidated in order to pay the death taxes.

It has been estimated that our capital stock in this country will increase by two-thirds of \$1 trillion over 8 years if we repeal this tax. Let's grow the economy and help the Government in that way rather than destroying the economy in order to help the government.

I thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Rep. Christopher Cox, a Representative in Congress from the State of California

ON BALANCING THE BUDGET IN A LOW-TAX ENVIRONMENT

Chairman Archer, I want to commend you for your leadership in holding these hearings today, and I welcome the opportunity to talk about the urgent need for tax cuts. I know most of my colleagues on this Committee agree with me that it is *absolutely essential* that the budget be balanced in a low-tax environment.

We are all working in this Congress to achieve a balanced budget, but to do this without tax cuts would be a grave mistake. A balanced budget in and of itself will do little to encourage economic growth in this country if it is based upon high rates of taxation and government spending.

Taxes which directly tax savings and investment are even more detrimental to our economy—by increasing the cost of capital they slow the rate at which the economy can expand and they make it more difficult for all Americans to save.

The key to an effective balanced budget is the level of taxation we can tolerate, not the amount of spending we want. It is imperative that we determine the appropriate amount of spending from the amount of tax disruption that spending causes, not by how many programs we like here in Washington D.C.

I'd like to focus my testimony today on the capital gains tax and the estate tax—the source of much of our tax code's bias against savings and investment. The current capital gains tax and estate tax dramatically increase the cost of capital, penalize savings, disproportionately damage small businesses—slowing economic growth and hurting federal payroll and income tax collections that would otherwise take in more under a healthier economy.

Specifically, I'm here to call for a 50% cut in the capital gains rate and complete repeal of the federal estate tax. These two elements should be a crucial part of our goal of balancing the budget in a low-tax environment. I hope that this Committee will make it a priority to approve cuts in both of these anti-growth, unfair taxes, so that we can send legislation to President Clinton this year.

These two tax cuts complement each other in a number of ways, aside from their inherent damage to our nation's growth. The effect on revenue from cutting these taxes will, far from hurting federal tax collections, in fact lead to increased revenues, especially in the short term from increased capital gains realizations, and in the long term through increased payroll, income taxes, and corporate tax collections that will arise from more vigorous economic growth.

The historical evidence is irrefutable—carefully-crafted capital gains *rate* cuts can increase tax revenues:

- In 1982, the capital gains tax rate was cut to 20%. The Joint Committee on Taxation predicted a massive loss in government revenue. Yet, over the next five years, capital gains realizations increased by 362%; federal revenue from the capital gains tax grew 385%, from \$12.9 billion in 1982 to \$49.7 in 1986.

Precisely the opposite phenomenon occurred in 1986, when Congress decided to increase the capital gains tax rate.

- In 1986, the capital gains tax rate was hiked from 20% to 28%—an increase of almost 40%. The Joint Committee on Taxation told us that this would be a great way to raise more funds for the U.S. Treasury. Yet, in the first year alone, both realizations and revenues plummeted, falling 56% and 34% respectively. This was hardly a one-time phenomenon: even in 1996, the 28% tax rate was still producing revenues significantly less than the 20% rate that had been in effect in 1986.

Cutting the current capital gains tax rate in half, as Republicans proposed last year, could generate *\$20 billion in additional revenues* over the next six years, according to testimony presented to the House Small Business Committee.

Repeal of the federal estate tax, by contrast, would have its greatest effect on the economy and on federal tax collections just as the initial effects of reducing the capital gains tax rate are beginning to stabilize. Repeal of the estate tax will allow vast reserves of capital to be put to their most productive use—not hidden away, diverted from business operations for estate planning, or not driven into less efficient uses as estates are liquidated to pay the tax man. These burdens—compliance and enforcement costs, and litigation—consume 65 cents for every dollar collected by the estate tax.

Repeal of the estate tax will lead to dramatically increased federal tax collections from income and payroll taxes after a few years:

- Repealing the estate tax this year would boost annual economic growth by \$11 billion, create 145,000 new jobs, and raise annual personal income by \$8 billion, according to the Heritage Foundation.

- As a result of this additional economic growth, federal payroll and income taxes will be more than enough to offset any short-term revenue loss from estate tax repeal.

- A retrospective study of the economy over the last 20 years showed that net annual federal revenues would have been *\$21 billion higher* if the estate tax had been repealed 20 years ago.

Mr. Chairman, too many people inside the beltway seem to think that they know what is best for the American people better than the American people do. This kind of thinking results in dangerous concepts such as paying for tax cuts, as though the money belongs to the government rather than to the people.

Our tax code today punishes savings, rewards spending, and double (and sometimes triple) taxes income, making it virtually impossible for parents to provide for their children and save for the future. It is basic human nature that after we have taken care of our immediate needs—food, clothing, shelter and the like—we want to make life better for our children and loved ones. I work, you work, and every American in this country works not just for himself or herself, but for his or her family, for those we care about.

Rather than seek to reverse human nature, which the death tax and the capital gains tax do, our tax code should tap this force as a powerful engine for wealth creation.

Again, Mr. Chairman, thank you for giving me the opportunity to testify before you today.

Chairman ARCHER. Thank you, Mr. Cox.

Our next witness is Hon. Collin Peterson from Minnesota, one of our colleagues familiar to us.

Welcome to the Committee, and you may proceed.

STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Mr. PETERSON. Thank you very much, Mr. Chairman, and I appreciate the opportunity to appear here today and testify, and we appreciated your coming over and visiting with our Blue Dog group the other day. A lot of us are interested in your idea of reforming the overall tax system and look forward to working with you on that.

As you are aware, we have spent a lot of time within our group trying to put together a budget that we think gets us to balance, and we have put off, as you know, tax cuts until after we get the budget balanced for a number of different reasons, most of which it is very hard to get this accomplished and make all of the numbers work, given the way we have to score things. We are not against tax cuts, however. We just think we ought to put them off until after we get the budget balanced.

And so, we have been advocating for a long time that we should split this process up, and we should take the budget. As one vote and one bill and take the tax cuts as another bill. We are very gratified to see that there appears to be some interest and some movement in that direction, and we think that would be very useful. We think that that would be a way we could maybe get through this whole situation and actually get a balanced budget put in place.

Obviously, we think we have the best budget out there. We have a CPI, consumer price index, change in our budget which allows us to do some things that we think are very positive, some of which have not gotten a whole lot of notoriety. We are proposing taking the Social Security Trust Fund offbudget in the year 2005 and putting it back in its own fund like it used to be and taking the other trust funds offbudget by the year 2007. One of the reasons we are able to do that is because we have the 0.08 change in the CPI in our budget.

So, having said all of that, we have a task force we have set up to work with you and your Committee and also to work with the administration, and we are ready to do that. However, what I am going to say now is going to be my own views, because we have not come to any conclusion on where we are at within the Blue Dog group. I have looked at the President's tax proposals. I think some of the education things maybe make some sense, but in my mind, the most important thing we need to do is if we are going to look at tax cuts, we need to focus on the things that are going to do the best for the economy, and I think those things are capital gains changes, estate tax changes, and I would add to that some changes in the alternative minimum tax.

I can go into a lot of reasons why I think the capital gains change makes a lot of sense, but in my district, the most important thing is most farmers are 58 years old, and they are having a hard time turning over their operations to their kids or to the neighbors. It is this capital gains structure that we have now which is locking up a lot of assets that would be better off if they were turned over. We have got a lot of apartment buildings out there that have owners who really do not want to own them any more, who bought them for tax shelters, and that was screwed up in the 1986 Tax Reform Act. They are not being turned over because of the capital gains situation. There are just a lot of reasons, in my view, why we need to change the capital gains provisions.

And the one thing I would say that I personally would prefer that we look at, not at an across-the-board capital gains change, but I think we ought to phase it in based on the length of time that you own an asset. Maybe a simple way to do it would be that you get a 10-percent exclusion from income for every year that you own the asset, so, you would get the 50 percent if you owned the asset 5 years. I think that that would be a more equitable way to put a capital gains provision in place, and there are a number of folks within the Blue Dog group who agree with me on that. We are asking Joint Tax to score that and see what that looks like.

There are also a number of us, myself included, who think we need to make changes in the estate tax, that we need to raise the unified credit; we need to look at the rates; we need to look at, potentially, some targeted relief for small businesses and for family farms who are having the same kinds of problems they are having with capital gains in the estate tax area. And I also think we need to look at the alternative minimum tax. I am a former tax preparer and personally get involved with this AMT, alternative minimum tax, every year, and there are just a lot of problems in that area. I think we need to look at taking depreciation out of there or, if not taking it out, making some changes, and I think that is an area that needs to be looked at.

And I also think, from my perspective, that we need to take a look at section 1245 gains. That is something you do not hear a lot about, but I think that is something that could be a lot of benefit for people in my district. Farmers, especially, get all tangled up with that provision.

So, there is a lot of support within our group, and I think on the Democratic side, for changes in the estate tax, changes in the capital gains rate. We think it would be good for the economy; we think it would be good for the country. But, having said that, I think most of us are going to say if we are going to do these things, they need to be paid for. We would like to see them done in a separate bill and done in a way that they are scored so they are not going to cost the Treasury any money. And if we can split these two things up, and if we can figure out how to pay for them, I think you will find quite a bit of support on the Democratic side for that.

Thank you.

[The prepared statement follows:]

**Statement of Hon. Collin C. Peterson, a Representative in Congress from
the State of Minnesota**

First of all, I want to thank the Chairman and the Committee for giving me the opportunity to present this testimony today. The Blue Dog Coalition, of which I am a member, met with Chairman Archer recently to discuss our commitment to overall reform and our willingness to work with the Chairman and the Committee on these issues. To that end, the Blue Dog Coalition has formed a Tax Reform Task Force to work with this Committee and with the Administration. The Coalition position which we have been advocating for a long time is that tax cuts should be split from the rest of the budget and the two issues should be voted on separately; in our view, any tax cuts must be paid for by cuts in spending or by changes in entitlements. Although we are not in favor of cutting taxes until we balance the budget, we are not opposed to tax cuts as long as they can be paid for with spending cuts or entitlement changes, and we can balance the budget in an honest way.

I am Co-Chairman for the Tax Reform Task Force for the Coalition. However, the testimony that I am giving today is my own position. I strongly believe that if we are going to have a tax cut, and if we can pay for it, that it makes sense to have a tax cut which will be beneficial to the productivity of our economy. If there is to be a tax cut which we can pay for, the top priority should be to make capital gains changes, estate tax changes, and some modification of the alternative minimum tax.

CAPITAL GAINS

I think it was a mistake to eliminate the capital gains preference in the 1986 Tax Reform Act. I know that in my district, the 7th District of Minnesota, there are a lot of long-term capital assets that need to be turned over. We have family farms where parents want to turn over the farm to their children. Small family-run businesses and apartment owners also want to turn over their assets to their families; however, these changes are not occurring because of the current capital gains structure. If we create an incentive for families to turn over their assets, the turnovers will result in increased productivity of the assets and increased vitality for the economy. The new owners will upgrade the assets by putting more money into them, improving their value, and making them more productive.

However, we should not return to the capital gains provisions that were in place prior to 1986. Instead, we need a program which rewards long-term investments in capital assets and capital markets. To that end, I believe that it makes sense to structure a capital gains reduction based on the length of the owner's holding of their asset. This would not make Wall Street happy, but they have not had a problem in attracting capital in the last few years. The reduction could be simply structured so that the exclusion from income increases along with each successive year that the owner holds the asset. The structure would involve a 10% exclusion from income for the first year. This reduction would increase to 20% in the second year and so on until reaching 50% after five years. This structure would not only be less expensive to maintain, but would also reward capital invested over a long period of time from those people who build up small family businesses or farms for over a period of years.

In addition, we could better target our capital resources by eliminating depreciation in the calculation of alternative minimum tax. We also should take a look at how we treat section 1245 gains. The current provisions are having a negative impact on capital formation and the long-term viability of certain businesses.

ESTATE TAXES

Along with the changes in capital gains, we need to also consider increasing the present-law unified estate and gift tax credit amount. We are open to suggestions on what the amounts of increase should be, and how they should be implemented; however, the bottom line is that these increases in exemptions and credits must be paid for. We also should consider making additional exemptions for small family-owned businesses and family farms when these assets are transferred within the family unit.

CONCLUSION

In making these changes, I believe that we will generate positive economic activity. By unlocking assets through changes in the capital gains structure, increasing the estate tax exemption, and making changes to the alternative minimum tax, we can increase the value and productivity of these assets, and raise considerable revenue for the Treasury. I believe that these changes would be good for the economy

of the country, and good for the people of my District. also think we need to look at the alternative minimum tax. I am a former tax preparer and personally get involved with this AMT, alternative minimum tax, every year, and there are just a lot of problems in that area. I think we need to look at taking depreciation out of there or, if not taking it out, making some changes, and I think that is an area that needs to be looked at.

Chairman ARCHER. Thank you, Mr. Peterson.

Our last witness in this panel is Hon. Earl Pomeroy. We are happy to have you with us, and we will be pleased to receive your testimony.

STATEMENT OF HON. EARL POMEROY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. POMEROY. Thank you, Mr. Chairman. I will summarize my testimony as briefly as I can.

For the last year, I have focused on the growing concern about whether Americans are saving enough for retirement. There is some frightening data out there that suggests that our savings rates are falling far short of what Americans will need for their retirement. In fact, the savings rate in this country has fallen by about half of what it was in the years between World War II and 1980 to now dipping under 4 percent in 1994.

One in three baby boomers, as estimated by Merrill Lynch, is on track with their private savings to augment their retirement needs, and the use of the individual retirement accounts has mirrored these trends. Since the 1986 Tax Reform Act, rates of taxpayers contributing to IRAs has fallen by 75 percent. In my testimony this morning, the component of the President's tax relief proposals I am talking about, obviously, relates to his proposals to expand the individual retirement account, which I believe is a critical strategy in terms of helping step up the rate of private retirement savings for people in this country.

Social Security was never intended to be the sole source of people's retirement income, and it certainly is not going to be able to meet that as baby boomers move into retirement. The tax-preferred individual retirement accounts are an excellent way to encourage such savings, and I think, really, the only discussion we have relative to that is how much IRA expansion can we afford? I suggest we apply two priorities to expanding the IRA: First, expanding access for middle-class Americans so they can step up their retirement savings rates and do so by enjoying the tax savings of a tax-deductible IRA; second, we need to reach those who are not able to save for retirement and devise new strategies that encourage savings among these taxpayers.

The President's plan with respect to expanding access to the IRA, I think, does an excellent job. Doubling the income limits of households and individuals able to contribute to an IRA and deduct the amount from their taxable obligation would take it to \$100,000 per household, \$70,000 per individual. You would make 20 million more Americans able to have a tax benefit from contributing to an IRA under this recommendation, and that is an excellent start. I

am convinced it will step up IRA participation and retirement savings.

In the area of what else we do, you have to look, I think, at how much you can afford. There is a proposal introduced in the Senate and House relative to open-ended IRAs, no limit on the top-end deduction. The scoring, at least to date, is that that would cost you about \$25 billion, compared to the President's package, costing about \$5.5 billion. I think you need to look at the area where you do not have people contributing to savings, and, of course, common sense tells us just what the data shows us: Those who cannot afford to save for retirement are those who are struggling to meet the needs of normal living expenses.

In fact, of workers with incomes of less than \$25,000, fully 42 percent report no retirement savings; 18 percent no retirement savings in income ranges between \$25,000 and \$40,000; 9 percent with incomes over \$40,000. Now, I believe we need to devise a strategy to incent those at lower earning levels to also do something for their own retirement savings needs, and a feature of legislation that I have introduced, H.R. 17, would do just that. It would allow for individuals earning less than \$35,000 and households earning less than \$50,000 a 20-percent, nonrefundable tax credit for whatever they contributed to the IRA. In other words, if they contributed \$1,000 to an IRA, they would actually have their final tax liability reduced by \$200. I think you could market this as a \$1-in-\$5 match by the Federal Government, very analogous to an employer match in a 401(k) situation that has proven so very successful at incenting additional participation in private retirement savings.

A final note, Mr. Chairman: If the purpose of IRA expansion is to incent retirement savings, the more early access you allow to the IRA accounts, the less retirement savings you are going to have at the end of the day. Therefore, I am concerned the President has proposed a number of exceptions that allow early access to the funds that you are actually undercutting what you are trying to achieve, and that is accelerate private retirement savings so that people have their own assets to help with retirement income.

I thank you, Mr. Chairman, for hearing me and wish the Committee well in its difficult deliberations.

[The prepared statement follows:]

Statement of Hon. Earl Pomeroy, a Representative in Congress from the State of North Dakota

Chairman Archer, members of the Committee, thank you for the opportunity to appear before you this morning. As we all recognize, the topic we discuss today—how to stimulate savings and investment while maintaining progress toward a balanced budget—is one of critical importance to the economic health of our people and our nation.

While this morning's hearing touches on three different components of President Clinton's fiscal year 1998 budget proposal—the expansion of individual retirement accounts (IRAs), the broadened exclusion for capital gains and the modification of the estate tax, I wish to focus my remarks exclusively on IRA expansion.

Americans are not saving adequately for retirement. For most of the post-World War II period, personal savings as a percent of disposable income in this country averaged nearly 8%. Yet in recent years, personal savings rates have fallen dramatically, even dipping below 4% in 1994. Use of individual retirement accounts by the American people has mirrored these trends. While 16.2 million individuals made IRA contributions in 1986, this number dropped—by nearly 75%—to 4.3 million in 1994. Much of this reduction was attributable to the Tax Reform Act of 1986, which

substantially curtailed the number of individuals who could claim the tax benefits of IRAs.

Mr. Chairman, I have devoted much of my time in Congress to the issue of retirement security, and I firmly believe that we must pursue a national strategy to reverse these trends and encourage greater savings for retirement. While we wrestle with the difficult question of how to reform the Social Security system to ensure its long-term solvency, we must remember that Social Security was never intended to be the sole source of retirement income. Rather, it was intended to augment personal savings and an employer pension. Given this critical role that personal savings plays in assuring financial security in retirement, and given the inadequacy of Americans' savings efforts, we must make encouraging private retirement savings a top priority.

Tax-preferred individual retirement accounts are an excellent means to encourage such savings, and we must take steps to expand access to these accounts. The only question is how much IRA expansion we can afford given the need to balance the federal budget by 2002. As we grapple with these questions of affordability, I suggest that our priority for IRA expansion must be two-fold. First, we must expand the number of middle income households who have access to this important incentive to save for retirement. And second, we must find ways to encourage use of IRAs by those working families who are presently unable to save.

The data demonstrates that middle income families are simply not saving enough for retirement. In fact, only one in three baby-boomers is on track for a financially secure retirement according to a recent study by Merrill Lynch. And with the first of the baby-boomers turning 50 this past year, their window to save for retirement is rapidly closing. To help these and other middle income Americans reach financial independence in retirement, we must take steps now to accelerate the rate of private retirement savings.

With respect to this first priority—expanding IRA access for middle income families—I believe the President's FY98 budget proposal achieves this goal in a responsible way. I have long advocated for and fully support the President's proposal to double the amount that individuals with workplace retirement plans may earn—to \$70,000 for individuals and \$100,000 for households—and still qualify for tax-deductible IRA contributions. In fact, my own IRA legislation, the IRA Savings Opportunity Act of 1997—H.R. 17, would make this same reform. With this single step of doubling income eligibility levels, we can restore the tax benefits of IRAs to as many as 20 million middle income families.

Whether to raise the income eligibility levels further than this is really a question of what we can afford in the current budget climate. While the doubling of the income caps has been scored at a cost of \$5.5 billion over five years, the outright removal of the income caps—as authorized in the Super IRA legislation introduced in the House and Senate—has been scored at a five-year cost of nearly \$25 billion. My belief is that it would be better to devote some of these funds to achieving the second priority of encouraging IRA use by working families who are presently unable to save.

When it comes to this second priority, I believe the President's budget could do more. Statistics confirm what common sense tells us—that savings correlates with disposable income and that low-wage workers have great difficulty saving for retirement. According to a recent study by the Public Agenda Foundation, among workers with incomes of less than \$25,000, fully 42% reported no retirement savings whatsoever. In contrast, only 18% of those with incomes between \$25,000 and \$40,000 and 9% of those with incomes over \$40,000 reported being unable to accumulate retirement savings. IRA participation rates tell the same story. In 1982 when the IRA tax deduction was available to all taxpayers, 56% of households with earnings greater than \$50,000 contributed to an IRA compared to only 19% of households with earnings between \$20,000 and \$25,000. These IRA participation disparities have continued even as eligibility for the IRA deduction has been curtailed for those at higher income levels.

Mr. Chairman, what these statistics tell us is that families at the lower end of the wage scale must be given a little extra help if they are to be able to save for their own retirement. Providing such help is in all of our interests. It will not only create new savers who will help spur the economy but it will also reduce the number of individuals who must later turn to the government for assistance when Social Security alone proves insufficient to meet their basic needs.

My IRA legislation, H.R. 17, attempts to provide this help by giving an added tax incentive for low-wage workers to contribute to an IRA. Under my bill, individuals earning less than \$35,000 and households earning less than \$50,000 would be entitled to a non-refundable tax credit equal to 20% of the amount contributed to an IRA. For example, a taxpayer in this income range who contributes \$1,000 to an

IRA would see his or her final tax liability reduced by \$200. This tax credit component of my bill resembles the employer match feature of 401(k) plans, which has proven so effective in encouraging low and moderate income workers to contribute to retirement plans in the workplace. The effect of the tax credit is that for every \$5 the taxpayer puts toward retirement savings, the federal government kicks in an additional dollar. I believe this tax credit approach will prove effective at achieving the second priority of IRA expansion—creating new savers among those who are not saving today.

Addressing these two key priorities—expanding access to IRAs for middle income families and encouraging IRA use by those not presently able to save—will require substantial resources. If we are able, however, to devote additional funds to IRA expansion after reaching these goals, there are certainly additional reforms that would help working and middle income families accumulate adequate retirement savings. One measure I have included in my IRA Savings Opportunity Act would allow middle income individuals without access to a workplace retirement plan—a group for whom personal retirement savings is especially important—to double their annual IRA contribution to a total of \$4,000. Another measure I have included in my legislation would remedy a glaring inequity in current IRA law by allowing an individual to take an IRA deduction irrespective of whether his or her spouse is covered by a workplace retirement plan. For the first time, this reform would allow working women whose husbands are covered by a workplace retirement plan to deduct contributions to their own IRA. Another helpful reform, which is contained in the President's FY98 budget proposal, would be to index both the income eligibility levels for IRA deductions and the \$2,000 annual IRA contribution amount so that inflation will not eat away at the IRA benefits we restore to middle income Americans.

The President's IRA proposal and a number of others include authorization of a limited number of penalty-free withdrawals. I believe these proposals require us to reevaluate the basic purpose of the IRA tax incentive. If the purpose of the incentive is to encourage savings for retirement—as I believe it is—then I am concerned that by providing access to the accounts for non-retirement purposes we will undercut the ability of the IRA to achieve its policy objective.

Mr. Chairman, members of the committee, as you move forward to consider the various IRA expansion proposals put forth by the President and others, I encourage you to focus your efforts on addressing the two key priorities of expanding access to IRAs for middle income families and encouraging IRA use by those not presently able to save. I thank you for your time this morning, and I look forward to working with you in the coming weeks and months to craft a budget plan which contains targeted and meaningful savings incentives.

Chairman ARCHER. Thank you, Mr. Pomeroy, and the Chair compliments each of the witnesses for their presentation, and I think each of them has been exceedingly constructive in moving us to what I hope will be the ultimate goal, which is a zero tax on savings in the United States of America. But every movement that we can get in that direction is a very constructive one.

Do any Members wish to inquire?

Mr. Christensen.

Mr. CHRISTENSEN. Mr. Chairman, I just wanted to applaud Mr. Deutsch, even though he is not here, on his testimony. I have never heard it quite so eloquently put by a Member of the other side on the confiscatory nature of capital gains and how punishing a tax it really is on savings and investment. I really want to applaud his leadership, and I really look forward to working with him on this issue.

Congressman Cox, I wanted to ask you a quick question: Obviously, I applaud your efforts both on capital gains and on the death tax issue. If you were to have to choose between the two, and hopefully, we would never have to do that, but if you were to focus your efforts on one or the other, which would be the better of the two

to work on to try to get this country going, and in terms of a confiscatory task, what would be your comments on that?

Mr. COX. Well, to put it the other way, I think it is the same question answered from either angle: Which of these taxes would you most like to keep? I would say that that question is logically equivalent to asking me whether I would prefer to be hit by a truck or a bus. Neither of these taxes has any place in a rational system where tax policy animates the Code. But let me explain from the premise of tax policy why the death tax is even worse than the capital gains. I like to call the capital gains tax a penalty tax on savings and investment. That is a more apt description than capital gains, which is some Internal Revenue Code jargon. Capital gains really does penalize savings, and it penalizes investment, and it is a penalty tax.

And since our savings rate is so abysmally low, I was just mentioning to Congressman Dreier here that Alan Greenspan has told us the average financial assets owned by an American between the ages of 45 and 53 is—anybody want to guess? David and I are the same age; we are 44; we will turn 45 next year. So, next year, we will graduate into this class of 45- to 53-year-olds. And according to Greenspan, the average financial assets held by Americans between the age of 45 to 53—and guess yourself what that number was.

Mr. DREIER. Tell them what my guess was.

Mr. COX. My guess was \$10,000. It is \$2,300, and when you hear this aggregate statistic of America's low savings rate compared to everybody in the world, this is a great way to personalize it: \$2,300 in financial assets for Americans between 45 and 53. So, a tax that penalizes savings and investment is doing grave damage to our economy.

But the estate tax goes beyond being a penalty tax on savings and investment. It is certainly that, but it has been called a virtue tax. Sometimes, in Ways and Means, you talk about sin taxes. Let's tax alcohol, tobacco, what have you. If you have got to tax something, why not tax sin? But the estate tax is a virtue tax, because not only is it a penalty tax on savings and investment, but it also penalizes work. The Code calls capital gains passive income, but if you continue to work beyond what is required to put clothes on your back, a roof over your head, food on the table so that you can take care of your loved ones, which is a human urge, you are penalized by the estate tax. You are penalized for doing what we want you to do, which is to continue to work, continue to provide for other people, continue to pay taxes, quite frankly. And, at the same time, you are rewarded for sin: You are rewarded for conspicuous consumption; you are rewarded for early retirement. None of these things should be incited by our Tax Code.

And so, while I go back to my original analogy, which is that this is like getting hit by a truck or a bus, if you ask me which is worse, capital gains or the death tax, I would get rid of the death tax.

The red light is on. I just want to share with you one very poignant story. A city council member in my district—it is a part-time city council—in his real life is an estate tax lawyer, and he came to see me the other day about city business, but he said I really am glad that the Congress is looking to repeal the death tax, be-

cause while I do this for a living, I have to tell you: I hate what I do for a living in many ways. Just the other day, I spent several hours at the bedside of one of my clients who passed away that day, and this happens not infrequently, because this is what I do for a living. And he said what I was doing with this man, and it took me the better part of 1 hour, was getting him to sign documents to create nothing in economic reality but tax avoidance so that he would not pay the estate tax. And the consequence of my being there was that if he signed the documents, he would not have to pay these taxes, but if he did not sign the documents, he would. Otherwise, there is no economic reality.

He signed the papers, and I went home, and he died, and I talked to his wife and his kids on the way out, and I thought how sad that our government creates a situation in which this dying man is spending his last hours on Earth with me, the tax lawyer, instead of with his wife and his kids. This is an awful, immoral, grotesque tax, and I would repeal it.

Mr. CHRISTENSEN. Well, thank you, and I applaud Congressman Dreier and H.R. 14, and I equally echo your sentiments that I would like to see them both repealed.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Christensen.

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

This has been an extremely impressive panel. I must say it has been one of the best discussions we have had before this Committee since I have been on it on a variety of tax issues that really affect the dynamics of the economy. I appreciate all three of you who are still here for staying here, and particularly, I appreciate Representative Peterson bringing up the alternative minimum tax, which I think is a terribly antigrowth provision in our Tax Code, a dead drag on our economy, and one that frequently gets dropped out of the discussion, so I am most grateful.

Representative Dreier, it has been a privilege to work with you to push for broad-based capital gains relief. There is a discussion as we move toward tax cuts as to whether it is better to have broad-based capital gains relief or try to carve out some areas where the capital gains tax is particularly punitive. And so, there have been a number of proposals for targeted capital gains relief. I wonder if you could briefly generalize on how strongly you feel about broad-based relief and why it is essential that it be in any tax package we do.

Mr. DREIER. Well, thank you very much, and as I said in my statement, I appreciate the fact that you responded to my call last fall when we looked to put this whole package together, and I appreciate your leadership on it. I mentioned in my statement this issue of human capital juxtaposed to physical capital, and I am one of those who has a very difficult time with having the government make choices as to whose capital should be taxed at a different rate. I am convinced that when we look at this proposal, it is going to boost wages overall if we bring this about. A study that was done in 1993 found that we could boost wages by \$1,500 for working Americans over a 5-year period, and we continue to hear about family tax cuts. Remember, those expire, and these do not.

So, that is why I think this broad-based package is not something that is going to simply target individual areas, but it is going to have an overall benefit in wages to people. So, that is a reason that is not often discussed as to why a broad-based reduction would be beneficial. But again, I laud the President for focusing on education. We are all very concerned about it, but it is only half of the equation. We have got to make sure that job opportunities are out there, and this kind of investment will go a long way toward doing that. And then, again, I mentioned earlier this recession problem that we might potentially have, and I see this as an insurance policy to help avoid recession. So, I think that on an overall basis, it can be very, very beneficial for us.

Mr. ENGLISH. Thank you; that is a very powerful summary, and I appreciate it.

Representative Cox, you gave a history of revenue under changes in the capital gains tax that, in my view, is absolutely unanswerable, and I wish this message were pounded into people more not only in this institution but also within the news media and the general public. I wonder: Reflecting on that, and having been here much longer than I have, and having seen the process of tax reform move forward, I think you and I both would support real tax reform right now. Do you believe that dynamic scoring is an important thing to move toward now as part of our effort to get toward tax reform that will really work and will really grow the economy?

Mr. COX. I think honest scoring is what we need for a change. The debate about dynamic and static has gone off in an odd, tangential direction. It means to some people adjusting data or cooking the books or guessing. The truth is that what we actually do, and I do not know what you want to call it, whether you want to call the status quo static or what have you, but the current arrangement between CBO and Joint Tax, whatever its label, is characterized chiefly by its false results. It is a fraud. It is so far off the mark that it should be rejected out of hand for almost any other system.

The empirical data, which I cited, is readily available to this Committee and to this Congress, but it goes well beyond our experience from 1978 to 1986 and our experience then forward from 1986 to now. We have, of course, the Kennedy tax cuts. We have the Mellon tax cuts. We have Mexico's experience. We have Canada's experience. We have empirical data coming out our ears, and the only thing we know about our arrangements with CBO and Joint Tax is that they produce consistently false promises. They overpromise and cheat the Treasury when it comes to taxes, because they tell us that by keeping the capital gains tax rate where it is, we will get revenues that, frankly, we are not going to get or alternatively that, by reducing that rate, we will lose revenues where, in fact, we would eclipse the current levels.

We are cheating the Treasury. We are cheating the Treasury. It is not a question of being able to give more tax relief to the American people than we presently do. The government of the United States is being cheated out of revenues because of this system. That is not a conservative system; that is a stupid system.

Mr. ENGLISH. Thank you, and thank you, Mr. Chairman.

Chairman ARCHER. Does any other Member wish to inquire?

Mr. CRANE. May I just make a comment?

Chairman ARCHER. Mr. Crane.

Mr. CRANE. First of all, I want to congratulate all of our witnesses for their commitment to strong tax policy and equity in our Tax Code, and I want to congratulate Chris Cox on his efforts to eliminate the death tax and on his commitment to eliminate the stupid capital gains tax.

One observation I wanted to make relates to an article, and I think I may have sent it out to you already from Investors Business Daily with regard to the death tax, pointing out that it brings in 1 percent of our total revenues annually. Over 7 years, they say, and these are projections by former Treasury economists, if you eliminated it, you would lose about \$100 billion in revenues, but you would cause a creation of \$630 billion in increased capital. I cannot help but believe that anyone who sits down and analyzes these figures cannot reach the same conclusions that you presented eloquently in your testimony, Chris.

So, I encourage you—I have been a cosponsor of your bill; Kenny Hulshof and I have one in, too, that eliminates that death tax, and I would hope we would get the growing bipartisan consensus that Collin referred to and guarantee that we do ultimately abolish the tax. Of course, it must be within the context of a balanced budget, too, but we must provide this kind of meaningful relief for overburdened Americans.

Mr. COX. Chairman Crane, I would just add that precisely for the reason you stated, the so-called loss in revenue over a period of years is not, in fact, that loss in revenue, because that is not all that happens. This is not a closed system in which all that exists is a death tax. We have plenty of other taxes, and if you are increasing economic growth by \$11 billion a year, then obviously, you get to tax all that growth, and that offsets it. It is the same thing as if we zero out capital gains. Nobody thinks we are going to lose revenues to the Treasury—or, at least, I should not say nobody; but most people do not think that. But, of course, we would lose them from capital gains taxes, because there would not be such a tax any longer. We would just pick it up elsewhere.

Likewise, if we repeal the income tax, and we have a consumption tax, it is not that the Government gets zero revenues; it gets them from a different place.

Mr. DREIER. If I could just add to that, Phil. In 1993 I mentioned that to the Zero Capital Gains Tax caucus that we put together. We found that over a 7-year period, a rate that actually ends up right around what we have in H.R. 14, which is a 14- to 15-percent rate, would over that period of time increase the gross domestic product by \$1.3 trillion, create 1 million jobs, and generate \$220 billion in revenues to the Treasury. And where we are is actually the rate that, it seems to me, would optimize those revenues to the Treasury specifically from capital gains revenue.

Mr. CRANE. Well, I have argued for years that taxing capital gains, taxing interest, taxing dividends, all those taxes do violence to all of the moral values we were taught and we try to instill in our kids, notwithstanding these penalties in place. I have seen economic reports in the past which suggest that, but if your objective is to maximize revenue on the one hand and the creation of capital

on the other, the ideal rate is somewhere between 9 and 12 percent. Now, I do not know where the economists reached those conclusions. I would like to see it all eliminated 100 percent.

Mr. DREIER. Right.

Mr. CRANE. But you might go back and revise your bill and ratchet it down.

Mr. DREIER. OK.

Mr. CRANE. Thank you.

Mr. DREIER. That is just in the interest of Chairman Archer, I know.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you.

David, these estimates that are so positive that you and Congressman Cox and my friend Phil and others talk about are the numbers I want. I want to make certain they are accepted by the House, the Senate, and the President. I do not see how we can talk day in and day out, year after year, about this and not be reading from the same rule book. I mean, why do we do this to each other?

Now, either we have got to get rid of the way we estimate revenue losses or we have to live by the rules as they now exist. I am not saying the estimates are always accurate. I think any economist would have a difficult job no matter what they estimate. But why would we debate the issue of estimating methodology when we are forced to go by the rules as they are today? And your alternative rule book is not commonly accepted.

Mr. DREIER. Well, first, Chris and I have been making the case for accuracy, and I appreciate the fact that you recognize some validity to it. But let's go—and I tried to respond to you in my testimony on that—let's look at this whole package that we had. The President's budget says he can bring it in balance with \$100 billion of tax cuts. H.R. 14 has been scored by CBO and Joint Tax at \$44 billion. It seems to me that if we look at the tremendous benefits, which I have tried to outline here, along with what you are convinced, and based on the scoring we have gotten, which I disagree with, but we have gotten it playing by those rules. It is a \$44 billion cost.

So, that is why I think being less than half the President's, it is a responsible way to proceed, because, as Jennifer Dunn said in her statement, this is the most important item we can do in trying to deal with this issue of balancing the budget, economic growth, and increasing wages.

Mr. RANGEL. OK; as long as when we finish, we are reading from the same rule book that—

Mr. DREIER. Well, I am just trying to read from your book right now, Charlie.

Mr. RANGEL. Well, it is not my book. It is the one that they have given me, and I just hate, once I understand that book, for people to start changing rules, even if I like your way better. You can be more creative; have more imagination and—

Mr. DREIER. And accurate.

Mr. RANGEL. If I found some way to agree with you about this scoring, if I can say that if we make an investment in the future of our children, we will get a dividend that we can depend on—for example, if we could project that a better educated child is going

to make more money, be more successful, stay out of trouble, and be a good citizen, then I could like that kind of scoring. And I think that is one solution to the scoring debate—that is, if people want to use dynamic scoring, they take a broad range of things into consideration on the outlay side, as well as the revenue side. But until the estimators use a system like that, we might as well play by the rules that now exist. If the estimators are saying that your bill will cost \$44 billion, then we must find a way to pay for that.

Mr. DREIER. I am glad you will find it.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, gentlemen. One last, quick question, and then we will excuse you and go to our next panel. In your bill H.R. 14, what do you do about the recapture of depreciation?

Mr. DREIER. We do not have any change in depreciation at all. We simply have indexation along with that reduction of the top rate from 28 to 14 and then the lower rate from 15 to 7½.

Chairman ARCHER. But let me be sure I understand. Then, you would require the recapture of depreciation of ordinary income, at the 28-percent rate.

Mr. DREIER. Right, right; that is correct.

Chairman ARCHER. Which current law does—

Mr. DREIER. That is correct.

Chairman ARCHER [continuing]. Before you compute the capital gains rate.

Mr. DREIER. That is correct.

Chairman ARCHER. Thank you very much and thank you for your excellent testimony.

Mr. DREIER. Thank you very much, Mr. Chairman.

Chairman ARCHER. The Chair would inform the Members of the Committee, as well as future witnesses or anybody else concerned, that it is the intention of the Chair to recess at 12 noon for 1 hour and to reconvene at 1 p.m. to continue the hearing today.

So, the Chair invites our next panel: Mark Bloomfield, Jane Gravelle, David Wyss, Richard Woodbury, and Thomas Wiggans to come to the witness table.

Mr. Bloomfield, the Chair recognizes you as our first witness, and in the event you were not here earlier in the day, we would encourage you to keep your verbal presentation to 5 minutes or less, and without objection, your entire statement in writing will be inserted in the record.

Mr. Bloomfield, welcome. We will be pleased to hear your testimony.

STATEMENT OF MARK BLOOMFIELD, PRESIDENT, AMERICAN COUNCIL FOR CAPITAL FORMATION; ACCOMPANIED BY DR. MARGO THORNING, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST

Mr. BLOOMFIELD. Thank you, Mr. Chairman. My name is Mark Bloomfield; I am president of the American Council for Capital Formation, and I am accompanied by Dr. Margo Thorning, our senior vice president and chief economist. We are very grateful for the opportunity to present testimony to the Committee on the subject of capital gains taxation.

Mr. Chairman, I would like to make three points today. First, let me set the predicate for a well-crafted capital gains tax cut. That predicate has two parts. One, trends in U.S. capital formation are not encouraging. Slow growth in the United States over the past two decades can be partially attributed to low levels of investment. A recent international comparison by the World Bank suggests that countries with high levels of investment grow faster than countries with relatively low levels of investment. The United States, for example, was in the bottom quarter of 16 countries surveyed in both the level of investment and average real GNP growth. Two, tax policy, Mr. Chairman, has an important impact on capital formation and economic growth. To those who would like to encourage individual and business decisions to save and invest, stimulate economic growth and create new and better jobs, capital gains and other forms of savings should not be taxed at all. This view was held by top economists in the past and by many mainstream economists today.

Second, let me summarize the positive macroeconomic impact of a sound capital gains tax cut, and I am drawing on two new analyses of two types of proposals before this Committee. The first, basically, is a 20-percent maximum capital gains tax for individuals and a 25-percent corporate tax rate. The second would be a 14-percent individual rate, a 28-percent corporate rate and indexing for inflation. This is the proposal of Mr. Dreier and others. These studies that I am mentioning were done by mainstream economists Dr. Allen Sinai, chief global economist, Primark Decision Economics, and DRI/McGraw-Hill, the prominent economic analysis firm represented by David Wyss on the panel today. Their results, I believe, would be helpful to address the questions of Mr. Rangel, Mr. English, Ms. Dunn, and others on the Committee today about the revenue impact and economic impact of a capital gains tax cut.

A soundly crafted capital gains tax cut, number one, would increase jobs and economic growth. New analyses by Alan Sinai and DRI/McGraw-Hill show that a broad-based and carefully crafted capital gains tax cut for individuals and corporations reduces the cost of capital, increases investment, GDP, productivity growth, and employment. In addition, such a cut would essentially be revenue neutral when unlocking and macroeconomic consequences are included.

Number two, it would benefit middle-class taxpayers. A 1996 CBO draft report documents the widespread ownership of capital assets among middle-income tax payers. According to the CBO report, in 1989, 31 percent of families with income under \$20,000 held capital assets, not including personal residences, and 54 percent with incomes between \$20,000 and \$50,000 held capital assets.

Number three, encourage entrepreneurship. Capital gains has a particularly powerful impact on the Nation's entrepreneurs, and is a major driving force for technological breakthroughs, new startup companies, and the creation of high-paying jobs. Starting new businesses involves not only entrepreneurs but also informal investors, venture capital pools, and a healthy public market.

Number four, it would promote U.S. savings and investment. The United States taxes capital gains more harshly than almost any other industrial country, according to an OECD survey of 12 indus-

trialized countries. Most of these countries also have had higher rates of investment as 1 percent of GDP than the United States over the past two decades.

Let me conclude with the case for a soundly structured, broad-based capital gains tax cut. By reducing the cost of capital, it would promote the type of productive business investment that fosters growth, output, and high-paying jobs. By increasing the mobility of capital, it would assure that scarce saving is used in the most productive manner. By raising capital values, it would help support values and capital asset markets in general and the stock market in particular. By increasing the availability and lowering the cost of capital, it would aid entrepreneurs in their vital efforts to keep the United States ahead in technological advances and translate those advances into products and services that people need and want. By reducing taxes on their savings, it would treat fairly those thrifty Americans who must bear a heavier tax burden than the profligate, and because of the combined impact of unlocking and the macroeconomic feedback from mainstream economic firms, a broad-based capital gains tax cut is likely to at least not be a revenue loser and maybe even increase Federal revenues.

[The prepared statement follows:]

Statement of Mark Bloomfield, President, American Council for Capital Formation

INTRODUCTION

My name is Mark Bloomfield. I am president of the American Council for Capital Formation (ACCF). I am accompanied by Dr. Margo Thorning, our senior vice president and chief economist.

The ACCF represents a broad cross section of the American business community, including the manufacturing and financial sectors, Fortune 500 companies and smaller firms, investors, and associations from all sectors of the economy. Our distinguished board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, prominent business leaders, and public finance experts.

The American Council for Capital Formation has led the private-sector Capital Gains Coalition since 1978, when the first major post-World War II capital gains tax cut was enacted. The Coalition brings together in support of capital gains tax relief diverse participants from all sectors of the business community: venture capital, growth companies, timber, farmers, ranchers, small business, real estate, securities firms, and the banking and insurance industries.

This testimony begins with a discussion of trends in U.S. capital formation and productivity growth, and the impact of tax policy on economic growth. Then we specifically address the macroeconomic effects of capital gains tax reductions. We conclude our testimony by setting forth three criteria that a good capital gains tax cut should meet: it should make economic sense; it should be fair; and it should be fiscally responsible.

We commend the emphasis that Chairman Archer has placed on the impact of capital gains taxation on the cost of capital, saving and investment, and economic growth. A capital gains tax cut will help reduce the burden on capital formation imposed by current U.S. tax policy. That tax policy must be revised if real wages for U.S. workers are to increase, living standards are to advance at a faster pace, and the United States is to maintain the economic strength necessary to sustain its leading role in world affairs.

TRENDS IN U.S. CAPITAL FORMATION, PRODUCTIVITY INCREASES, AND ECONOMIC GROWTH

Slow growth in the United States over the past twenty years can be partly attributed to low levels of investment. A recent international comparison by the World Bank suggests that countries with high levels of investment experience faster growth than countries with relatively low levels of investment. This relationship is clearly demonstrated in Table 1 and Figure 1.

International comparisons aside, even more disturbing is the fact that net annual business investment in this country has in recent years fallen to only half the level of the 1960s and 1970s. As shown in Table 2, that rate dropped from an average of 8.9 percent of GDP in the 1960s and 1970s to 4.8 percent in the 1990s.

Harvard Professor Dale W. Jorgenson, one of the nation's foremost public finance economists, emphasizes the overwhelming importance of investment in plant and equipment for economic growth in his recent volume, *Productivity Postwar U.S. Economic Growth*. Professor Jorgenson's study analyzes economic growth between peaks in the business cycle over the 1948–79 period. Allocating increases in output to three sources: growth in the capital stock, labor supply, and multifactor productivity he found that increases in the capital stock had the strongest impact on growth in output.

Studies by University of California Professor J. Bradford De Long and Deputy Secretary of the Treasury Lawrence H. Summers also conclude that investment in equipment is perhaps the single most important factor in economic growth and development. Their research provides strong evidence that, for a broad cross section of nations, every one percent of GDP invested in equipment is associated with an increase in the GDP growth rate itself of one-third of one percent, a very substantial social rate of return.

TAX POLICY AND ECONOMIC GROWTH

To those who favor a truly level playing field over time to encourage individual and business decisions to save and invest, stimulate economic growth, and create new and better jobs, capital gains (and other forms of saving) should not be taxed at all. This view was held by top economists in the past and is held by many mainstream economists today.

This is primarily because the income tax hits saving more than once first when income is earned and again when interest and dividends on the investment financed by saving are received, or when capital gains from the investment are realized. The playing field is tilted away from saving and investment because the individual or company that saves and invests pays more taxes over time than if all income were consumed and no saving took place. Taxes on income that is saved raise the capital cost of new productive investment for both individuals and corporations, thus dampening such investment. As a result, future growth in output and living standards is impaired.

A consumption-based tax system, under which all saving and investment would be exempt from tax, would be more favorable toward capital formation and economic growth than is our current income tax system, according to analyses by top public finance scholars over the past decade and a half. Studies by Stanford University's John Shoven and Lawrence Goulder, Harvard's Dale Jorgenson, the University of Texas Don Fullerton, and Joel Prakken of Macroeconomic Advisers have used macroeconomic models that incorporate feedback and dynamic effects in simulating the impact of adopting a consumption tax as a full or partial replacement for the income tax. These studies, which use different types of general equilibrium models, conclude that U.S. economic growth would be enhanced if we relied more on consumption taxes, or replaced the income tax with a fundamental tax restructuring plan similar to those proposed by several prominent members of the U.S. Senate and House of Representatives in recent years.

In addition, at a recent forum on dynamic revenue estimating sponsored by the Joint Committee on Taxation, the majority of the economic modelers concluded that if the United States switched from the existing income tax to a broad-based consumption tax, the rate of economic growth would increase significantly.

MACROECONOMIC IMPACT OF CAPITAL GAINS TAX REDUCTIONS

In their search for methods of stimulating saving, investment, and economic growth, policymakers should give strong consideration to lightening the tax burden on investment through a significant capital gains tax reduction.

Low capital gains taxes not only treat savers more fairly but also help hold down capital costs. Public finance economists refer to the tax on capital gains as a tax

on retained income. It is retained income that funds a large part of business investment. The higher the capital gains tax, the more difficult it is for management to retain earnings (rather than pay out dividends) for real investment in productive projects.

Although the short-term outlook for the U.S. economy is favorable, worries about the future appear to be multiplying. For example, many public finance experts such as Professor John Shoven conclude that this country's long-term strength and economic stability depend on increasing saving and investment to ensure that the retirement of the baby boom generation does not sink the economy into a sea of red ink. A cut in the capital gains tax to a top marginal rate of 15 to 20 percent would by no means act as an economic panacea. However, it would surely help encourage saving, help maintain the values of capital assets (e.g. real estate and stocks), promote investment by both mature and new businesses, and more fairly tax individual savings.

Substantial reductions in capital gains taxes for individuals and corporations would have important economy-wide consequences:

INCREASE JOBS AND ECONOMIC GROWTH

A new study by Dr. Allen Sinai, president and chief global economist at Primark Decision Economics and the WEF&A Group and a highly respected economic forecaster, concludes that a well-crafted, broad-based capital gains tax rate reduction has significant benefits for the U.S. economy.

Dr. Sinai's analysis demonstrates that a broad-based capital gains tax proposal providing a 50 percent exclusion for individuals and a 25 percent corporate capital gains tax rate would reduce the cost of capital (defined as the pretax return required by investors) by almost three percent. Reduced capital costs lower the hurdle rate for new business investment and induce increases in the rate of growth of capital formation, investment, productivity, GDP, and employment (see Table 3). Lower capital gains taxes support the value of equities as well as other capital assets.

A capital gains tax reduction would also tend to shift the financing of business activity from debt to equity, and induce portfolio allocations by households toward equity to take account of changes in expected after-tax returns on stocks and bonds.

BENEFIT MIDDLE-CLASS TAXPAYERS

Investments in capital assets are widely held by the middle class. According to data compiled by the Investment Company Institute, almost 60 percent of households with income of \$50,000 or less own mutual funds. A 1996 Congressional Budget Office (CBO) draft report also documents the widespread ownership of capital assets among middle-income taxpayers. According to the CBO report, in 1989, 31 percent of families whose incomes were under \$20,000 held capital assets (not including personal residences) and 54 percent with income between \$20,000 and \$50,000 held capital assets.

Middle- and low-income taxpayers also hold a significant share of the total dollar value of capital assets, even when personal residences are excluded. The CBO study shows that 30 percent of the dollar value of such assets (excluding housing) was held by families with incomes of \$50,000 or less in 1989.

ENCOURAGE ENTREPRENEURSHIP

Capital gains taxation has a particularly powerful impact on this nation's entrepreneurs. These individuals are a major driving force for technological breakthroughs, new start-up companies, and the creation of high-paying jobs. Starting new businesses involves not only entrepreneurs but also informal investors, venture capital pools, and a healthy public market. All taxable participants are sensitive to after-tax rates of return, which is why the level of capital gains taxation is so important.

Foremost is the entrepreneur. If the tax on potential capital gains is a higher rate, either the pool of qualified entrepreneurs will decline or taxable investors will have to accept a lower rate of return. In either case, the implications for the U.S. economy are clearly negative. To be successful, the entrepreneur needs capital. Fledgling start-ups depend heavily on equity financing from family, friends, and other informal sources. Professors William Wetzel and John Freear of the University of New Hampshire, in a survey of 284 new companies undertaken in the late 1980s, found taxable individuals to be the major source of funds for those raising \$500,000 or less at a time. The point to be stressed is that individuals providing start-up capital for these new companies pay capital gains taxes and are sensitive to the capital gains tax rate.

Small businesses and entrepreneurs face higher capital costs than Fortune 500 companies. For them, a significant capital gains tax differential can make a big difference in their decisions affecting jobs and growth.

RAISE TAX RECEIPTS

Critics of lower capital gains taxes argue that such cuts will reduce federal revenues and thus add to the budget deficit, absorb national saving, and raise interest rates and capital costs. Both economic analysis and experience effectively refute this view.

Scholars have researched and debated two elements affecting capital gains tax revenues, the unlocking of unrealized gains and the macroeconomic impact of a low tax on capital gains.

Revenue estimates used in congressional and Treasury Department analyses ignore macroeconomic impacts but do incorporate an unlocking or behavioral response on the part of taxpayers to changes in capital gains tax rates. Estimates of unlocking are extremely sensitive to assumptions about the elasticity of taxpayer response. Very minor differences in assumptions can result in large differences in expected revenues.

In the late 1980s, experts at the prestigious National Bureau of Economic Research (NBER) examined the question of the revenue-maximizing capital gains tax rate: At what point is there sufficient unlocking to compensate for the static revenue loss resulting from a reduction in the tax? The NBER study by former Harvard Professor Lawrence Lindsey (a recently retired member of the Board of Governors of the Federal Reserve), which was based on academic models of the responsiveness of taxpayers to changes in the capital gains tax rates, found that the revenue-maximizing rate ranged between 9 and 21 percent. The NBER study did not take into account the additional revenue stemming from the positive macro consequences of increased employment and growth which result from a significant reduction in capital gains tax rates.

Although government revenue estimates do not factor in the macroeconomic consequences of lower capital gains tax rates on U.S. capital costs, investment, and economic growth, previous research indicates these effects can have a favorable impact on overall tax revenues. In addition, the new dynamic analysis by Dr. Sinai shows that the government could gain revenue from a capital gains tax reduction (see Table 3).

Actual experience also indicates that lower capital gains taxes have a positive impact on federal revenues. The most impressive evidence involves the period from 1978 to 1985. During those years the top marginal federal tax rate on capital gains was cut almost in half from 35 percent to 20 percent but total individual capital gains tax receipts nearly tripled, from \$9.1 billion to \$26.5 billion annually.

PROMOTE U.S. SAVING AND INVESTMENT

Our international competitors recognize the contribution a lower capital gains tax rate can make in promoting capital formation, entrepreneurship, and new job creation. The United States, on the other hand, taxes capital gains more harshly than almost any other industrial nation. A survey by the OECD of twelve industrialized countries shows that the U.S. capital gains tax rate on long-term gains on portfolio securities exceeds that of all countries except Australia and the United Kingdom, and these two countries index the cost basis of an asset (see Table 4). Germany, Japan, and South Korea exempt or tax only lightly capital gains on portfolio stock. Not only do virtually all industrialized as well as developing countries tax individual capital gains at lower rates than the United States, they also accord more favorable treatment to corporate capital gains (see Figure 2).

It is important to note that most of the countries shown in Table 1 have had higher rates of investment as a percentage of GDP than the United States over the past two decades. This fact may in part reflect the encouragement of saving and investment due to their lower capital gains tax rates.

CONCLUSION

A soundly structured, broad-based cut in tax rates on capital gains would significantly benefit all Americans. By reducing the cost of capital, it would promote the type of productive business investment that fosters growth in output and high-paying jobs. By increasing the mobility of capital, it would help assure that scarce saving is used in the most productive manner. By raising capital values, it would help support values in capital asset markets in general and the stock market in particular. By increasing the availability and lowering the cost of risk capital, it would

aid entrepreneurs in their vital efforts to keep the United States ahead in technological advances and translate these technological advances into products and services that people need and want. By reducing taxes on their savings, it would treat fairly those thrifty Americans who must bear a heavier tax burden than the profligate. And, because of the combined impacts of unlocking and macroeconomic feedback, a broad-based capital gains tax cut could increase federal revenues.

Mr. Chairman, the case for an early broad-based cut in capital gains tax rates is exceedingly strong. We urge this Committee and both Houses of Congress to enact such legislation at the earliest feasible time.

Country	Gross Domestic Saving	Gross Domestic Investment	Average Annual Real GNP Growth
South Korea	30.7	32.0	11.4
Singapore	40.0	41.8	7.6
Thailand	27.3	31.2	7.5
Hong Kong	30.4	28.6	7.3
Malaysia	34.9	31.7	6.8
Japan	32.3	30.9	3.6
Norway	30.0	27.7	3.5
Switzerland	24.9	24.0	3.1
Australia	23.2	24.3	2.7
Canada	23.5	22.7	2.7
Germany	23.7	21.0	2.6
United States	17.5	18.8	2.3
France	22.1	22.0	2.0
United Kingdom	17.4	18.1	1.6
Denmark	20.7	19.5	1.6

Source: The World Bank, *World Tables 1995* (Baltimore: The Johns Hopkins University Press).

	Average 1960–1980	Average 1981–1985	Average 1986–1990	Average 1991–1996***
Net Private Domestic Saving	8.1%	7.3%	5.3%	5.3%
State and Local Government Surpluses	2.1%	1.9%	1.8%	1.4%
Subtotal of Private and State Saving	10.2%	9.2%	7.1%	6.7%
Less: Federal Budget Deficit	-0.8%	-3.8%	-2.8%	-3.1%
Net Domestic Saving Available for Private Investment	9.3%	5.4%	4.3%	3.6%
Net Inflow of Foreign Saving*	-0.4%	1.2%	2.4%	1.3%
Net Private Domestic Investment	8.9%	6.7%	6.7%	4.8%
Gross Private Domestic Investment	16.0%	16.9%	15.4%	13.7%
Nonresidential Fixed Investment	10.4%	12.2%	10.5%	9.6%
Producers' Durable Equipment	6.6%	7.4%	6.9%	6.8%
Industrial Equipment	1.9%	1.8%	1.6%	1.6%
Producers' Durable Equipment Less Info, Processing and Related Equipment	5.2%	5.0%	4.6%	4.5%
Personal Saving	5.4%	5.7%	3.8%	3.6%
Net Business Saving**	2.7%	1.6%	1.5%	1.7%

*In the 1960–80 period the United States sent more capital abroad than it received; thus net inflow was negative during this period.
 **Net Business Saving = gross private saving - personal saving - corporate and noncorporate capital consumption allowance.
 ***Includes only first, second, and third quarter figures for 1996.

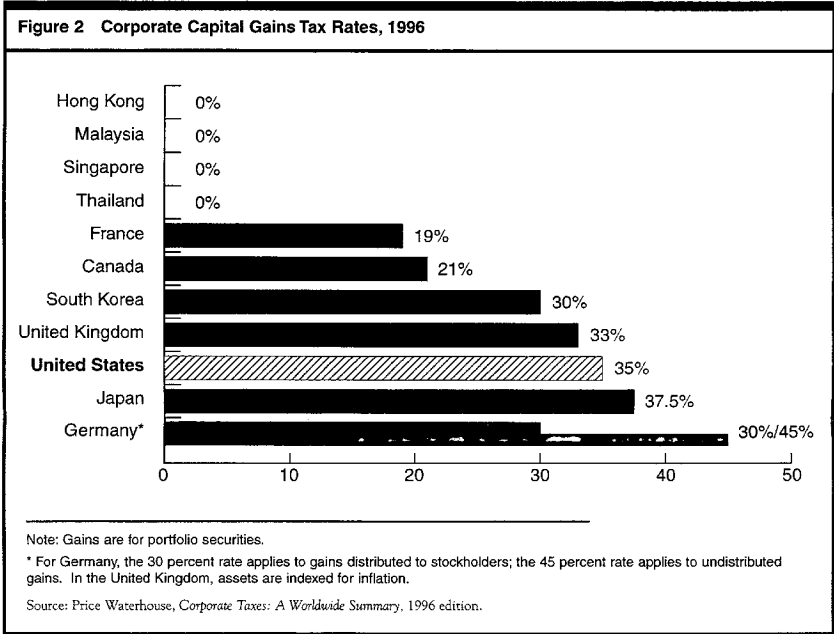
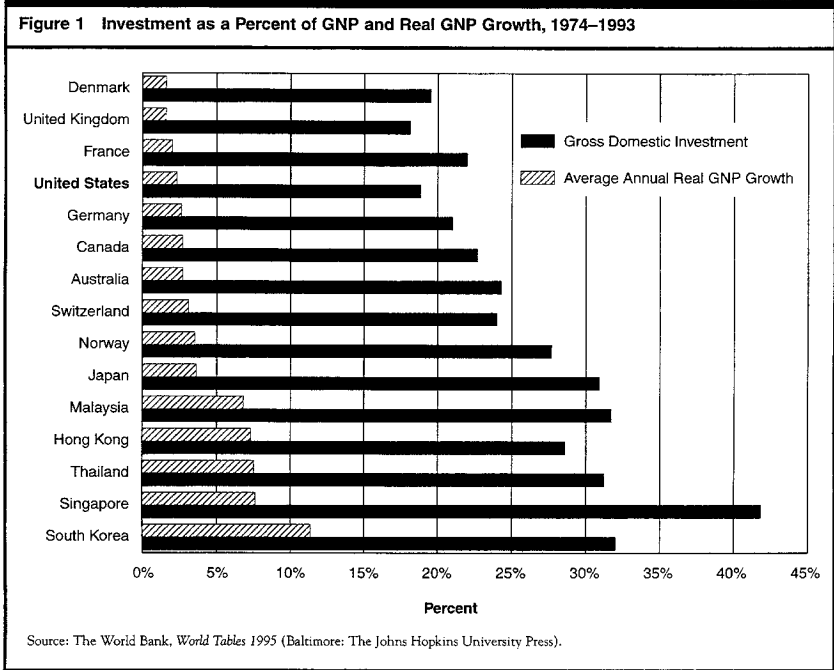
Source: Department of Commerce Bureau of Economic Analysis, National Income Accounts.
 Update prepared by American Council for Capital Formation Center for Policy Research, February 1997.

Table 3 Macroeconomic Effects of a Capital Gains Tax Reduction for All Taxpayers¹ (compared to baseline forecast)

	FY 1997-2002
Real GDP	
(average change per year in real \$)	\$51.0
(average change per year in GDP growth rate)	0.1%
Employment	
(average change per year)	356,000
Business capital spending	
Total (average change per year)	1.9%
Equipment	1.5%
Structures	2.7%
Cost of capital	
After-tax cost of debt and equity (average change per year)	-2.7%
S&P Stock Index	
(average change per year)	0.8%
Total federal tax revenues²	\$4.5-\$17.2
(billions of dollars)	
¹ Assumes a 50 percent exclusion for long-term capital gains for individuals and a 25 percent rate for corporate capital gains. ² The revenue impact varies according to the degree of unlocking assumed in response to a reduction in capital gains tax rates. Source: Testimony of Dr. Allen Sinai, chief global economist, Primark Decision Economics, Inc. and the WEFA Group, before the Senate Committee on Finance, March 13, 1997.	

Table 4 International Comparison of Capital Gains Taxes and Personal Saving Rates

Country	Capital Gains Maximum Individual Tax Rate ¹		Personal Saving Rate ²
	Short-term	Long-term	1975-1994
United States	39.6%	28%	6.4%
Japan	1% of sale price or 20% of net gain	1% of sale price or 20% of net gain	17.0%
Australia	48.3%	48.3%; asset cost is indexed	8.4%
Belgium	Exempt	Exempt	18.0%
Canada	23.80%	23.80%	11.9%
France	18.1%	18.1%	15.3%
Germany	53.0%	Exempt	12.6%
Hong Kong	Exempt	Exempt	N/A
Italy	25.0%	25.0%	20.7%
Netherlands	Exempt	Exempt	2.4%
Sweden	25.0%	25.0%	2.7%
United Kingdom	40%; asset cost is indexed	40%; asset cost is indexed	10.3%
¹ Reflects top marginal rates on portfolio securities gains. ² Organization for Economic Cooperation and Development. Net household saving as a percent of disposable income. <i>OECD Economic Outlook 57</i> , June 1995, Annex Table 26, p. A-29.			
Prepared by the ACCF Center for Policy Research.			



Ms. JOHNSON [presiding]. Thank you, Mr. Bloomfield.
Ms. Gravelle.

**STATEMENT OF JANE G. GRAVELLE, SENIOR SPECIALIST,
ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE**

Ms. GRAVELLE. Madam Chairman, Members of the Committee, I would like to thank you for the opportunity to appear before you today to discuss the President's capital gains tax cut proposals and the implications of capital gains tax cuts for savings and investment.

The President's capital gains tax cut is directed at owner-occupied housing. For most individuals, it would effectively eliminate capital gains tax on the sale of a principal residence. Because of the many ways to avoid paying this tax currently, a relatively small number of homeowners are subject to the tax. The President's tax proposal would have modest effects on savings and investment for two reasons: First, the provision is a small one, costing only \$200 to \$300 million per year according to administration estimates. The main benefits of the proposal are not so much in its effects on savings and investment but rather that it would relieve most homeowners of the onerous recordkeeping requirements, prevent people from making decisions based on tax avoidance motives, and perhaps be fairer to individuals who have a need to sell.

Even if the scope of the economic effect of the capital gains tax cut is larger, for example, because more general capital gains provisions might be considered, there is little reason to believe that significant effects on savings and growth will occur. First, we cannot be sure whether cutting capital gains taxes on capital income will increase savings. It may surprise you to know that economists have long recognized that the response of savings to the rate of return is theoretically uncertain due to the opposing forces of income and substitution effects. When the rate of return rises, a substitution effect might cause an individual to prefer more consumption in the future and save more, but at the same time, the income effect allows him to actually save less to reach a particular target.

Therefore, because of this theoretical ambiguity, it is necessary to turn to the empirical research. Unfortunately, the body of empirical research does not suggest a large positive effect on savings from increasing the rate of return, and, indeed some studies find a negative effect; that is, some studies indicate that cutting capital gains taxes might even reduce savings.

The process of altering the capital stock through change in the savings rate is also a very slow one, so that one would not expect large effects in the short run even with a large response. And finally, this type of tax cut would not have a large effect on output because it is not large in itself. This is true even for a broader capital gains tax cut, such as a 50-percent exclusion accompanied by indexing. I estimate that were that directly translated into reduction of the cost of capital, the exclusion would reduce the cost of capital by 9 basis points and with the addition of indexation by about 16 basis points, very small effects. That is simply because

the capital gains tax is not a very large part of our current tax system.

I would also like to briefly summarize the results of the simulation model I have developed that traces over time the response to a tax cut of this magnitude. In doing this estimate, I used those results from the literature that were actually conducive to a larger positive, in other words, they were very generous to a larger positive effect. Even after 5 years, I found the capital stock increased by less than two-tenths of 1 percent; the output level by only one-twentieth of 1 percent. After 110 years, output increased by only half of 1 percent.

To see why these effects are so small, let me discuss the first year. We might find the rate of return rising by about 4 percent. Using even a generous savings response, the increase in the savings rate would only be 1.6 percent, but savings is only about 2 percent of the capital stock, which means the capital stock will increase by only three-one hundredths of 1 percent and the output by one-one hundredth of 1 percent. Thus, even under optimistic assumptions, the effects of a larger capital gains tax cut are small.

Models that find very large effects of capital gains tax cuts are using very large elasticities and very fast adjustment periods that simply are not consistent with the economic evidence. I would like to also add that arguments that have been made that a capital gains tax cut will stimulate investment in the short run by causing a rise in stock market prices and lowering equity, in my view, are not consistent with correct economic modeling, because they do not trace the process by which this asset price occurs.

There have also been arguments that capital gains tax cuts may be important for venture capital. That may be true, but venture capital is a very, very small part of total investment in the economy. In the latest data I saw, it accounts for seven-tenths of 1 percent of total investment in the economy. Most capital gains tax cuts will not go to venture capital.

I do not mean by this discussion to imply that capital gains tax cuts are not desirable. There are arguments for and against them. But I think the important point for this Committee to remember is that probably the most direct and certain route to increasing savings is to increase the public sector savings by decreasing the deficit or increasing a surplus, should we ever have one. And in this context, I would like to add that the current revenue estimating by the Joint Tax Committee for capital gains is not static estimating; it includes a very generous dynamic estimate, and, in fact, that dynamic estimate might be a little too generous. So, I think it is very important to keep your eye on the revenue costs when you are considering capital gains taxes, if you are interested in the effect on long-run growth and savings.

Thank you.

[The prepared statement follows:]

**Statement of Jane G. Gravelle, Senior Specialist, Economic Policy,
Congressional Research Service**

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy at the Congressional Research Service of the Library of Congress. I would like to thank you for the opportunity to appear before you today to discuss the President's capital gains tax cut proposals and the implications of capital gains tax cuts for savings and investment.

The President's capital gains tax cut is directed at owner-occupied housing. For most individuals, it would effectively eliminate capital gains tax on the sale of a principal residence by allowing a \$500,000 exclusion for a married couple and a \$250,000 exclusion for a single person or head of household. This exclusion can be used once every two years. This proposal would replace two existing provisions. One provision allows deferral of gain that is rolled over into a new residence—if the new residence costs as much as the old, all gain is deferred. The second provision allows a one time \$125,000 exclusion for individuals aged 55 and over. And, of course, like any capital gains tax, the tax can be avoided completely if the asset is held until death.

Because of the many ways to avoid paying the tax, a relatively small number of homeowners are subject to the tax. These taxpayers are likely to fall into two categories: older individuals whose gains exceed the exclusion or who have already used the exclusion and younger individuals who are not eligible for an exclusion. In both cases, these would be individuals who desire to reduce their investment in housing, perhaps by buying a smaller residence or perhaps by moving into a rental unit or other living facility. In many cases, these individuals may be facing adverse circumstances (loss of health, or a decline in economic circumstances) that causes this contraction in housing consumption.

The President's tax proposal will have modest effects on savings and investments for two reasons. First, the provision is a small one, costing only \$200 to \$300 million per year according to Administration estimates. The main benefits of the proposal are not so much in its effects on savings and investment, but rather that it would relieve most homeowners of onerous record-keeping requirements, prevent people from making decisions based on tax avoidance motives, and perhaps be fairer to individuals who have a need to sell.

Note, however, that even though this provision is directed at housing, it might make more capital available to business use by reducing the lock-in effect of the housing capital gains tax. For example, individuals moving from a high cost to a low cost area may feel less pressure to reinvest in a large house, and individuals who would like to downsize and invest the proceeds elsewhere would be freer to do so.

In fact, this provision might have a larger behavioral effect than implied by its revenue cost, because it influences—and imposes an implicit burden on—those who do not pay tax. Indeed, the principal argument for simply allowing an exclusion for most people is that the current law, while collecting very little revenue, is costly because of its influence on behavior, as individuals seek to avoid the tax.

Even if the scope of the economic effect of a capital gains tax is larger, either because the current treatment has an implicit cost or because more general capital gains tax provisions might be considered, there is little reason to believe that significant effects on savings and growth will occur.

First, it may be surprising to some to learn that we cannot be sure whether cutting taxes on capital income will increase savings. Economists have long recognized that the response of saving to the rate of return is uncertain due to the opposing forces of "income" and "substitution" effects. When the rate of return rises, a substitution effect might cause an individual to prefer more consumption in the future (because the price of future consumption has fallen in terms of foregone present consumption) and increase savings. At the same time, there is an income effect—the higher rate of return can allow savings to be smaller and still increase consumption in the future (and in the present as well). For example, if an individual were saving a certain amount for retirement, he could obtain that objective with a smaller amount of savings when the rate of return goes up.

Because of this ambiguity, it is necessary to turn to empirical research to determine whether private savings will increase, and empirical evidence would be necessary in any case to determine the magnitude of any effect. While it is very difficult to perform this analysis, this body of research suggests that effects of higher rates of return on savings have small positive effects on savings behavior and, in some studies, negative effects.⁷ That is, some studies indicate that cutting capital gains taxes might even reduce savings.

The process of altering the capital stock through a change in the savings rate is a very slow one that takes many years. Even with a large percentage increase in savings, the effect on the capital stock and on economic output will be modest because savings is very small relative to the capital stock.

Finally, it is likely that the effect of the capital gains tax cuts on economic output and growth will be modest, even with a large response, because the tax change itself

⁷For a summary of this literature, see Jane G. Gravelle, *The Economic Effects of Taxing Capital Income*, Cambridge, Mass., MIT Press, 1994, p. 27.

is not that large relative to the economy. This is true even for a capital gains tax cut of much broader scope than that of the President's. For example, by my calculations, a fifty percent capital gains exclusion has the effect of reducing the cost of capital by 9 basis points, and the combination of the exclusion and indexation reduces the cost by about 16 basis points.⁸

I would like to briefly summarize some results of a simulation model that traces, over time, the response to a broader capital gains tax cut of this general magnitude, equivalent to a two percentage point reduction in the capital income tax rate, or a reduction in the cost of capital of 18 basis points. While taking my estimated responses from the economics literature, I used those results favorable to a larger positive effect of the tax. A savings response at the upper end of the estimates in the empirical literature is chosen. This response is in the form of a savings elasticity (the percentage change in the savings rate divided by the percentage change in the rate of return), and is set at 0.4. This estimate was reported by Michael Boskin in one of the earlier studies of savings response.⁹ Such a measure implies that a ten percent increase in the rate of return will lead to a four percent increase in the savings rate.

Several aspects of this simulation were chosen to be favorable to a large effect, including not only a larger, and positive, savings elasticity, but also an assumption that any revenue losses are recouped through some mechanism that does not otherwise alter the economy's economic behavior. Even after five years, however, the capital stock increased by less than $\frac{2}{10}$ of a percent, the labor supply by $\frac{1}{100}$ of a percent, and the output level by $\frac{1}{20}$ of a percent. Even after 110 years, output increased by only one half of one percent. Eventually, the process reaches a final equilibrium, which results in a 2.25 percent increase in the capital stock, a .07 percent increase in the labor supply, and a 0.62 percent increase in output.¹⁰

It is relatively straightforward to see why these effects are so small in the short run. Consider the first period after the rate of return rises. Suppose it rises by about 4 percent. That implies an increase in the savings rate of 1.6 percent (4% times the elasticity of 0.4). But savings is about two percent of the capital stock, which implies that the capital stock will increase by only $\frac{3}{100}$ of a percent. Finally, given that capital contributes only twenty-five percent of output, the effect on output is less than $\frac{1}{100}$ of a percent.

Thus, even under optimistic assumptions, the effects of even a much larger capital gains tax cut on savings appears to be small.

It is important to note that models that have found very large effects on the capital stock of tax cuts, including the capital gains tax cut, use the assumption of a very large savings response and a rapid adjustment period. Such an assumption is not grounded in statistical evidence from the economics literature.¹¹

More recently, arguments have been made that capital gains tax cuts will stimulate investment in the short run by causing a rise in stock market prices, which would make equity finance cheaper to firms. A consistent model of the economy would suggest two important limits on this process. First, total asset prices (of stocks and bonds) cannot rise unless there is some increase in overall purchases, which should be preceded by an increase in savings. Shifts between the two will do nothing for the cost of capital. Some attempts to model the effect of a capital gains tax cut begin by simply translating a lower capital gains tax into a higher stock market price, without taking account of the effects on interest rates. But asset prices are not set exogenously—they are a consequence of supply and demand, and depend on the nature of those supply and demand factors. If anything, a capital gains tax cut is a relatively indirect route to subsidizing investment, as, say, compared to an investment subsidy, since it first requires a bidding up of stock prices and then an expansion in equity finance.

Secondly, there is no reason to expect a permanent rise in stock market prices due to a capital gains tax cut. Even if asset prices increased, the value would fall

⁸This information and the simulation that follows was presented in greater detail to The Committee on Finance, United States Senate, February 15, 1995. The calculation of basis points reflected realizations in 1992; the effects might be somewhat larger because realizations may have been depressed in that year, but the magnitudes will be similar.

⁹Michael Boskin, *Taxation, Savings and the Rate of Interest*, *Journal of Political Economy*, vol. 86, January 1978, pp. S3–S27.

¹⁰In the long run, our concern is about changes in standard of living, that is available consumption in the steady state. Since the savings rate must be higher to maintain the normal growth of the higher capital stock, the percentage increase in consumption is slightly smaller, at 0.49 percent.

¹¹Note also that one argument used to justify a large savings response, international capital inflows, is not germane to this issue, since the capital gains tax applies to residents regardless of the location of capital and does not apply to foreign investors.

until stock prices again reflected the value of underlying assets. The expectation that this price effect would be transitory should moderate its effect in the first place.

Some have argued that capital gains tax cuts would be effective in increasing the amount of venture capital. Of course, there are already some provisions in the tax law that benefit new stock issues in small firms. In general, however, it is important to note not only that very little direct evidence for a strong response of venture capital exists, but, more importantly, only a very small part of capital gains tax relief would go to venture capital. According to data on venture capital commitments reported in a study by Poterba, formal venture capital accounted for only 7/10 of one percent of total investment. Moreover, most of the suppliers of venture capital are not subject to capital gains taxes, particularly individual capital gains taxes. (Individuals accounted for only 12 percent of funds).¹²

Returning to the general savings analysis, under less favorable assumptions (e.g., effects on the budget deficit are not offset and/or the relationship between savings and the rate of return is negative), the capital gains tax cut could contract the economy and slow economic growth by reducing national savings.

This discussion is not meant to imply that capital gains tax cuts are not desirable. There are some efficiency arguments in favor of capital gains tax cuts, particularly for corporate stock. Some people have reservations about cutting capital gains taxes, however, because of the distributional and revenue consequences. But as a route to increased savings, the evidence from economics—both theoretical and empirical—suggests some reservations about the efficacy of lower capital gains tax rates in increasing savings.

What alternatives might be more successful in increasing savings? Some highly stylized economic models suggest that tax provisions that benefit only new physical investment, as would occur with a shift to a consumption tax, might have a pronounced effect on savings. While these types of tax revisions might be more successful than tax cuts that benefit old capital, there is little evidence that such dramatic responses are likely. Periods in history that were characterized by such changes were not accompanied by the dramatic savings responses, especially in the short run, that some of these models predict.

While this analysis suggests that it is difficult to influence private savings via tax revisions, most economists do agree that there is one relatively straightforward way in which the government can increase national savings—increasing public sector savings. Reductions in the deficit or additions to a surplus would be likely to translate directly into increased savings. For that reason, most economists believe that it is important to ensure that adoption of tax incentives do not add to the budget deficit, if increases in national savings is an important goal.

Chairman ARCHER [presiding]. Thank you, Ms. Gravelle.
Mr. Wyss, we would be pleased to receive your testimony.

**STATEMENT OF DAVID WYSS, RESEARCH DIRECTOR, DRI/
MCGRAW-HILL, LEXINGTON, MASSACHUSETTS**

Mr. WYSS. Thank you, Mr. Chairman, Members of the Committee.

Chairman ARCHER. Did I pronounce your name correctly?

Mr. WYSS. Yes; it is W-y-s-s.

Chairman ARCHER. Thank you.

Mr. WYSS. I would like to thank you for inviting me to discuss capital gains taxation and its impact on the economy. I should start by saying that DRI has normally been pretty skeptical about ideas that tax cuts will raise enough revenue to pay for themselves, but I think capital gains is one area where this is true. The capital gains cut is one tax that does have enough leverage to increase the economy enough to pay its own bill, and it is one area where dynamic scoring, I think, is really required.

¹²James M. Poterba. *Venture Capital and Capital Gains Taxation*. In *Tax Policy and the Economy*, National Bureau of Economic Research, Cambridge, MIT Press, 1989.

Generally, dynamic scoring is the correct way to look at any change in the tax rates, but historically, it has fallen into disfavor because of overpromising, because it becomes an exercise in competitive dynamism, as everyone tries to outpromise everyone else. And, therefore, we have moved away from it. I really feel that by a consistent use of mainstream economics, looking at a variety of economic models, it would be possible to use it, but I realize that that is not the task of today's Committee meeting.

The capital gains tax is revenue neutral, not only or even primarily because of its impact on increasing economic growth. We actually feel the impact on the economy is relatively small because the capital gains tax is relatively small compared with the economy. You are talking about a tax reduction on the order of \$15 billion. Even with a lot of leverage—and we think capital gains does have a lot of leverage—our analysis indicates that real GDP is only increased by about 0.4 percent at the end of 10 years.

That does not sound like a lot, but I would like to remind people that that is about \$60 billion at that time, and if you think that is small enough not to pick up, I will be happy to take a finders fee on it. [Laughter.]

Mr. WYSS. It is also very large not just in absolute magnitude, but it is very large relative to the size of the tax cut. This means we are getting a multiplier of about four on the size of the tax cut. That is not enough to make it revenue neutral by itself, but it is a good start. Ordinary taxes paid on that are an offset to a good part of the capital gains cut.

The real leverage on revenues, however, comes not just from the impact on the economy but the impact of the capital gains tax in increasing asset values and increasing capital realizations. On the question of asset values, I do not think there is any mystery: Any investor is going to equalize the aftertax rate of return on various classes of assets. If you lower the rate of taxation on equity, for example, the price of equity has to go up in order to equalize the return between that and, say, Treasury bonds, which I see no reason to be affected by capital gains taxes. That means that increase in asset value eventually comes back to the Treasury. It is clawed back, to use a Briticism, in terms of higher capital gains receipts, albeit at the lower rate.

The third source of revenue comes from the increased turnover that you are likely to get as people are less locked in to their existing capital. The current capital gains tax creates inefficiencies in the market because people do not want to sell an inferior asset for fear of having to pay tax on it. Obviously, if you have complete capital gains in an asset, and you are being taxed at 28 percent, any asset you buy has to yield about 40 percent more than the asset you are selling just to make up for the tax payment you have to make up front to the Treasury. If this lock-in effect is diminished, people will turn over their assets more quickly, and this creates some additional tax revenue, particularly up front.

That additional revenue is important in the short run, because it is an offset, particularly in the first 5 years. There is an enormous amount of unrealized capital gain out there to turn over. Current estimates are that we have between \$6 and \$7 trillion of

unrealized capital gains in this economy. Even a very small increase in turnover would yield a large amount of tax revenue.

Overall, we believe that a moderate capital gains reduction, and the primary analysis we did was on S. 66, the Hatch-Lieberman bill, would result in neutral or, in our estimate, slightly positive revenue change. In other words, the bill is revenue positive. It raises more revenue than it loses on a static basis. If you reduce rates too much, this is no longer true, because you are clawing back at lower rates. Clearly, if you reduce tax rates to zero, the volume is not going to make up for the reduction in rates.

Exactly where the revenue maximizing rate lies, I am not certain. Our analysis suggests that it is below 28 percent; probably close to 20 percent. But we would like to do some more analysis over time to figure out where it should be.

The final analysis, though, is that even if it is only revenue neutral, the tax law change helps the economy. It helps productivity. It helps, obviously, the owners of capital, because they are taxed at a lower rate. It helps the workers because of the increase in capital stock, the increase in productivity, and the increase in employment. It raises enough revenue to pay for itself, so it hurts no one. If you have a bill which helps most people and hurts nobody, what is the possible reason for not doing it.

Thank you.

[The prepared statement follows:]

Statement of David Wyss, Research Director, DRI/McGraw-Hill, Lexington, Massachusetts

Mr. Chairman, members of the Committee:

Thank you for inviting me to discuss capital gains taxation and its impact on the economy. DRI/McGraw-Hill has long been skeptical about any claims that tax cuts will raise more revenue than they cost. The capital gains tax is the one tax, however, where this may be true. At least for moderate changes in the capital gains tax rate, our analysis indicates that the impetus the lower rate gives to asset valuation and to the economy roughly offsets the lower static tax revenues. Within a reasonable range of tax rates, the capital gains tax rates appears roughly revenue neutral.

This is one area where dynamic scoring really seems required. Dynamic scoring is, generally, the correct way to look at any form of taxation, but the problem with it historically has been the ability to distort the dynamic scores by letting wishful thinking dominate economic analysis. We feel by consistent use of economic techniques it is possible to do dynamic scoring. It is questionable whether it is possible to do it within a political framework.

The capital gains tax is revenue neutral not primarily because of its impact on the economy, but because of its impact on asset values. In general, we believe that the impact on the economy is relatively small. This would be expected. After all, the capital gains tax cut is only worth about \$15 billion on a static basis, and even with substantial leverage it is hard for \$15 billion to have an enormous effect on a \$7 trillion economy. Our analysis suggests that, even after ten years, the impact on overall GDP is 0.4%, clearly not an enormous number, but hardly a trivial one. In fact, over that ten year period, real GDP would be raised by an aggregate of over \$200 billion.

This may be a small share of GDP, but it is certainly a very large share of the \$15 billion annual static cost of the capital gains tax. Moreover, some additional tax revenue will come from the higher value of existing assets. When the capital gains tax rate is cut it increases the value of owning shares of stock. As the price of those shares rises, owners pay taxed on that increased amount. Those additional taxes offset the static revenue loss.

Additional revenue also comes from higher turnover. Capital gains taxes lock owners into their stock positions. People are unwilling to sell stock because if they sell the stock, they will have to pay capital gains at a 28% rate. Sub-optimal stock positions are thus locked.

The estimates of higher turnover are probably the most questionable part of any analysis of the impact of capital gains. In the past, capital gains cuts have usually come as part of larger tax packages. It is very difficult to disentangle turnover from the overall impact of the rest of the tax code. Moreover, capital gains realizations depend heavily on what has been happening in the stock market which is also moved sharply by changes in the capital tax. The unlocking effect seems clear from anecdotal reports and simple logic but its magnitude is somewhat questionable. We feel our estimates are conservative—additional turnover of only 5% of unrealized capital gains over the next ten years.

There will be some negative effect as taxpayers shift income away from ordinary income and into capital gains. If the capital gains rate is reduced, people have a greater incentive to take income in the form of tax-advantaged capital gains rather than ordinary income. The restriction of passive loss deductions, however, makes this a more difficult game to play than in the 1980s. We estimate the impact at about \$2 billion a year. Prior to the 1986 tax law we would have estimated a substantially higher figure, \$5 to \$10 billion annually.

Overall, we believe that a moderate capital gains reduction, on the order of that proposed in the Hatch-Lieberman bill, will result in a small gain in revenue. Too large a cut in rates, however, is no longer revenue neutral. Much of the clawback from revenue comes from applying the capital gains rate to the higher asset values. If the rate is reduced too far, the tax on the rise in assets is not sufficient to offset the static revenue loss. Our analysis of HR14, for example, indicates that the bill would be a significant revenue loser, costing well over \$100 billion on net over a ten-year period. The Dreier bill would have a greater impact on the economy and on the stock market, but because the stock market gains are taxed at a lower rate, it would not raise enough revenue to offset its cost.

This is not an argument against indexation. Indeed, our study suggests that indexation is more effective, dollar-for-dollar, than rate cuts. Indexation cuts rates only on future gains, and does not reward the past. We do caution against trying to cut the rate and introduce indexation, however.

One argument against a capital gains rate cut is that it accrues only to the rich. Although it is certainly true that the rich have more capital than the poor, the poor don't lose in a capital gains cut. Pension portfolios will gain in value, and the middle class have a rising portfolio of 401K plans. The great bulk of the assets of the middle class, and particularly the younger middle class, is tied up in their homes. More direct relief on capital gains in housing could spread the benefits more equally. But even if households have no capital assets themselves, they will benefit from the higher investment and resulting higher productivity created by the capital gains rate cut.

The capital gains cut helps most people and hurts no one. The overall impact on the economy, though small, is clearly positive. Reducing capital gains will not remake the economy, but it helps modestly at no cost to the Treasury. We find it difficult to understand why the bill should not be passed.

THE CAPITAL GAINS TAX, ITS INVESTMENT STIMULUS, AND REVENUE FEEDBACKS

The impact of a capital gains tax cut on the economy and on tax collections has been investigated for decades. The evidence suggests to almost all economists that a capital gains cut is good for the economy and roughly neutral for tax collections. Although static analysis of the tax suggests the federal government loses revenue, a dynamic analysis suggests that the government can gain revenue. Such dynamic gains depend on the time interval examined and on the feedback effects from a stronger economy. By encouraging investment, a capital gains tax reduction becomes a true supply-side tax cut, and perhaps the only cut that really might fully pay for itself.

Cutting the capital gains tax will boost investment by lowering the cost of capital to businesses. The only preferences now offered for individuals are a maximum rate of 28% for gains versus 39.6% for ordinary income, and the deferral of taxation on accrued gains until the underlying asset is sold. A new preference that included just 50% of the gain in ordinary income would thus cut the effective top marginal rate paid by capital gains recipients to 19.8% from the current 28%. Together with a reduction in the corporate rate on gains from 35% to 25%, this shift would, in a static analysis, lose about \$15 billion of federal revenue per year. (From the perspective of an investor facing both state and federal capital gains taxes, the current marginal tax rate on capital gains is 32%, assuming a 6% state and local rate deductible against the federal income tax. The new effective rate would be 23.5%.)

The lower tax rate on capital gains unambiguously raises the value of assets subject to the tax because the same, related stream of pre-tax earnings is now worth

more after-tax to the investor. This affects the stock market most. DRI analyzes share prices as the after-tax, discounted present value of dividends and capital gains (driven by retained earnings).

If all holdings were subject to the tax, the proposed lower tax rate on gains would need to raise share prices 8% to equalize the risk-adjusted rate of return on shares with that on bonds. This calculation assumes that bond yields would not be affected by the lower capital gains rate. It assumes that all of the correction required to avoid an unjustifiable yield differential is produced by a rise in the price-earnings ratio of stocks. This assumption of unchanged bond yields is reasonable when considering a solitary change in capital gains taxation. That is because bond yields represent the discounted value of future short-term interest rates, adjusted for risk, and there is no immediate reason why short-term rates should be affected by the solitary tax change.

However, we recognize not all asset holdings are subject to capital gains taxes. Tax-sheltered investments (such as pension funds and 401K and IRA holdings) and foreign investments now account for about half of all equity holdings. Assets passed through an estate without a sale before death escape capital gains taxes, although heavy estate taxes apply to any accrued appreciation plus the original principal invested.

As share prices rise in response to a tax rate cut in the above-noted scenario, the expected pre-tax rate of return of equity would drop, inducing non-taxable investors to shift into bonds. If we assume that the degree of risk aversion, and thus the trade-off between risk and return, is the same for these investments as for non-tax-exempt holdings, the impact on share prices will be reduced by their ratio to total holdings. This implies that in an environment with half the investors exempt from taxation, equity price-earnings ratios will rise by only 4%, half the 8% gain calculated above. Note that this would be a permanent increase in the price-earnings ratio corresponding to any given bond yield. Experience suggests that the move will not occur until the bill is signed by the President, but then it will come quickly.

The capital-gains tax cut would lower the net cost of capital by about 3%. This 3% estimated reduction is a blend of an 4% reduction in the cost of equity and an unchanged cost of debt finance. The core cost of equity equals the dividend yield (reduced 4%, as indicated above) plus expected dividend growth (assumed to be unchanged at about 6%). Other factors equal, this shift would raise the level of business spending by about 1.5%, or \$18 billion in 2007. Over a 10-year period, the capital stock would rise 1.2% above its baseline level, increasing productivity by roughly one-third this percentage, or 0.4%.

BUDGET IMPACT

The effect on capital gains tax collections is complicated and potentially controversial. However, a decomposition of the impact into discrete components can replace some of the emotion in the debate with rationally discussible magnitudes:

1. In a static analysis, the lower rates will reduce tax revenues proportionately.
2. However, lower rates unlock assets, creating higher turnover and increasing collections in the short run.
3. The higher value of assets, and thus asset prices, raises total capital gains, and thus increases revenue.
4. Income reclassification from ordinary income to capital gains will cut revenue.
5. The stronger resulting economy and higher GDP raises total tax revenue.

The static loss is easy to calculate since it is simply the change in the tax rate times the level of capital gains receipts. There are only two complications: first, there may be an impact on state tax revenues that are tied to federal income definitions and, second, capital gains taxes are not broken out separately in the statistics. Using estimates based on 1991 returns, the lower rate would lose about \$11 billion per year. Based on gains since 1991, we estimate the current impact at \$15 billion.

The unlocking/higher-turnover effect will increase revenues in the early years of the program. When the capital gains tax rate is reduced, assets become more liquid in the sense that the tax loss involved in selling them is a lower percentage of the asset's value. This switch makes individuals ready to sell more often, and by increasing the turnover raises revenue in the early years of the program. Estimates based on past CBO papers suggest that this unlocking could add \$10 billion to revenue in the first year. The additional revenue would diminish rapidly, however, since the change only moves forward the realization of capital gains. Under some models, the impact turns negative in the third and fourth year. In the long run, there is still some positive effect in our analysis because a higher turnover implies that fewer capital gains expire on the death of the owner.

The higher asset value will be the primary positive contributor to tax revenues. A 4.0% share price increase will raise total stock market valuation by \$280 billion. If 15% is sold within the first year (about the current turnover rate in the stock market) and taxed at 19.8%, this effect would raise capital gains revenue by \$8 billion. Taxable gains on other assets (primarily privately held businesses) might rise by about one-half this amount.

The increased gap between the ordinary income and capital gains rates will induce individuals to reclassify income in order to lower their tax liability. This income reclassification was, in fact, one of the primary reasons cited for going to an equal treatment in the 1986 tax bill. There is evidence to suggest that the change was successful in widening the income-tax base. Reversing this 1986 reform would clearly increase the incentive to convert ordinary income into capital gains, for example, by deferring income in closely held enterprises or shifting from wage income to stock options. The size of the impact is uncertain, but it could easily cost \$5 billion per year in reduced tax revenue. At least, this was the magnitude cited in 1986 when the change was made in the opposite direction. We have assumed only half this effect, since we believe the changes in passive loss rules make income-shifting less easy.

The stronger growth of the economy produced by a solitary change in capital gains taxation will add to both capital gains and ordinary income tax collections. Our model suggests that after 10 years real GDP could be 0.4% higher than in the baseline, because of the capital gains tax rate change and its repercussions on investment. In 1992 dollars, this extra growth would add \$34 billion to national income. In 2007 dollars, the impact would be \$116 billion, adding \$30 billion to federal revenue.

The usual static analysis does not consider either the increase in asset values or the impact of a stronger real economy. Only the rate reduction and the higher turnover and income reclassification are usually included in the analyses done by the Congressional Budget Office or other government agencies. The difference between the estimates illustrates the importance of using dynamic estimates of the impact of tax changes. Much of the literature from the extreme right, which indicates that the capital gains tax is a huge money-maker, illustrates the dangers as well.

This analysis so far has examined only the macroeconomic implications. The distribution of the benefits is also an important political and economic issue. A narrow view of the capital gains tax cut is that it will favor the wealthy, who have more capital than the poor. Although the rich get most of the gains, no one loses. Often overlooked benefits flow to all workers and middle income citizens, and the overall economy wins. The middle class will benefit from greater appreciation in their pensions, now increasingly structured as defined contribution plans in which all investment returns are captured by the employee. Small businessmen will gain from more generous tax treatment of the gains on their enterprise. And all employees will see wage gains tied to investment-driven higher productivity.

Table 1. Estimated Impact of a 50% Capital Gains Exclusion

(Federal revenues, billions of 1997 dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
Static Impact	(\$14)	(\$15)	(\$15)	(\$16)	(\$16)	(\$17)	(\$18)	(\$18)	(\$19)	(\$20)	(\$168)
Higher Turnover	\$15	\$8	\$5	\$3	\$2	\$3	\$3	\$3	\$3	\$3	\$48
Asset Prices	\$13	\$12	\$10	\$9	\$8	\$8	\$8	\$8	\$8	\$8	\$92
Income Reclassification	(\$2)	(\$4)	(\$2)	(\$2)	(\$2)	(\$2)	(\$2)	(\$2)	(\$2)	(\$2)	(\$22)
Higher GDP	\$0	\$1	\$2	\$3	\$5	\$7	\$9	\$10	\$12	\$14	\$63
Total	\$12	\$2	(\$0)	(\$3)	(\$3)	(\$1)	\$0	\$0	\$2	\$3	\$13

Table 2. Estimated Impact of Indexing Capital Gains with 14% Top Rate

(Federal revenues, billions of 1997 dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
Static Rate Impact	(\$23)	(\$24)	(\$25)	(\$26)	(\$27)	(\$28)	(\$29)	(\$30)	(\$31)	(\$33)	(\$276)
Indexing	\$0	\$0	\$0	(\$2)	(\$3)	(\$4)	(\$5)	(\$6)	(\$7)	(\$8)	(\$35)
Higher Turnover	\$16	\$8	\$5	\$3	\$2	\$3	\$3	\$2	\$2	\$2	\$47
Asset Prices	\$14	\$13	\$11	\$9	\$7	\$7	\$7	\$7	\$7	\$7	\$87
Income Reclassification	(\$2)	(\$3)	(\$3)	(\$3)	(\$3)	(\$3)	(\$3)	(\$3)	(\$3)	(\$3)	(\$29)
Higher GDP	\$0	\$2	\$3	\$5	\$8	\$11	\$14	\$15	\$18	\$21	\$95
Total	\$4	(\$4)	(\$9)	(\$15)	(\$16)	(\$15)	(\$14)	(\$15)	(\$14)	(\$14)	(\$112)

Table 3. Cumulative Impact of Tax Reductions in S. 66

[Total 1998–2007]

Real GDP (billions of 1992 \$)	\$185
Real capital spending (billions of 1992 \$):	
Business equipment	\$83
Total fixed investment	\$103
Capital stock (% difference)	1.1
Output per hour (% difference)	0.4
Cost of capital (% difference) (pretax return required by an investor)	-3%
Total federal tax receipts (billions of current \$)	+\$13

INDEXING CAPITAL GAINS

The proposal to index capital gains has a similar impact to the exclusion from tax. It also cuts the cost of capital to the firm, and raises the value of assets, including especially common stocks. The impact will depend on the amount of inflation expected by the market, and on the details of the law.

Over the past, inflation has accounted for about half of capital gains. That average, however, includes the high-inflation 1974–1985 period. We believe the market is currently discounting a 3% inflation rate, which would only account for about one-third of anticipated capital gains.

Our analysis assumes the indexation comes on top of a reduction in the capital gains rate to 14%, as in HR 14. Thus, the impact, or the cost of capital, is less than half as great as if it were done on its own. It also, of course, loses only half the revenue it would otherwise. Unfortunately, because the higher stock values are clawed back at a much lower tax rate, the dynamic scoring of the bill does not offset its static loss. A net loss of about one-third the static loss results.

This is not an indictment of indexation. In fact, our model indicates that indexation gives a greater impact on investment per dollar of tax revenue lost. The analysis does, however, suggest that although capital gains rates are revenue-neutral for moderate changes, if they are reduced too far they will lose revenue.

The additional static tax loss is very small in the near term, since the bill does not index for past (pre-1997) inflation. The impact builds over time, however, as more of the gains can be indexed. By 2007, the static loss from indexing is estimated at \$8 billion.

Asset prices will rise proportional to the effective reduction in the capital gains rate in future years. This means that although indexation has little immediate impact on the effective capital gains tax rate, it does have full impact on asset prices and capital costs. The increase in turnover is difficult to estimate in this bill. In general, indexation would have only a small near-term impact on turnover, since pre-1997 inflation is not forgiven.

Income reclassification is less likely with indexation than with exclusion. There is no advantage to reclassifying income as capital gains unless the underlying asset is held long enough and its base price is high enough to make the inflation adjustment attractive.

The impact on the economy is proportional to the impact on asset values. The economic impact results from the lower cost of capital to business, which increases investment. The marginal impact of adding indexation to the 50% exclusion is about one-third the impact of the exclusion. (Note that these magnitudes would have changed if done in the opposite order.)

SUMMARY

Our analysis shows that the Hatch Lieberman bill is essentially revenue-neutral. The static losses are largely offset by the increase in the value of assets and the stronger domestic economy over the ten-year period. Our analysis shows a marginally positive result, but well within the margin of error.

In essence, the bill does nobody any harm and does business and does a capital owner some good. The proposal lowers capital costs and thus raises business investment improving productivity and income growth in the long run. The higher incomes raise tax revenues offsetting about one-third of the static revenue loss. Most of the rest of the revenue loss is offset by the higher turnover of capital assets and by the increase in the value of the assets caused by the lower tax rate.

Combining a sharper reduction in the rate with indexation, as in HR 14, is not revenue neutral. There is a proportionate impact on the economy, and the stronger

domestic economy offsets nearly one-third of the rise of the static revenue loss, as in our analysis of Hatch-Lieberman. Asset values also rise, but these are clawed back at a lower tax rate and, therefore, do not offset as much of the revenue. Similarly, the higher turnover is taxed at only 14% instead of 19.8%, yielding a smaller impact on revenues. We, thus, find that the bill loses \$112 billion over a ten-year period, with only about two-thirds of the static loss made up by income gains elsewhere.

Chairman ARCHER. Thank you, Mr. Wyss.

Our next witness is Richard Woodbury. If you will identify yourself for the record, we would be pleased to receive your testimony.

STATEMENT OF RICHARD WOODBURY, PRESIDENT, WOODBURY CORP., SALT LAKE CITY, UTAH; ON BEHALF OF NATIONAL ASSOCIATION OF REALTORS

Mr. WOODBURY. Thank you, Mr. Chairman. My name is Rick Woodbury, president of Woodbury Corp., a real estate brokerage, management, and development firm located in Salt Lake City, Utah. I appear today on behalf of the National Association of Realtors, but part of my comments are also presented on behalf of several other national real estate organizations which are listed at the end of my statement.

First, I will comment on President Clinton's proposal related to owner-occupied residential real estate, then, on some issues of concern to commercial and investment real estate owners and investors. It is important to note that issues pertaining to capital gains on the sale of a principal residence are very different from capital gains issues pertaining to commercial and investment real estate. The proposal that taxpayers filing a joint return be permitted to exclude up to \$500,000 of gain on each sale of a principal residence is a dramatic simplification of the current law and should be viewed and supported on its merits as a simplification.

Under current law, rollover rules permit a homeowner to exclude the gain on sale of a personal residence from taxation so long as the proceeds of the sale are reinvested in homes of equal or greater value within 2 years. Also, there is a one-time exclusion of \$125,000 if the taxpayer is over 55 years of age. Although these rules have served families well, they are the source of very burdensome recordkeeping requirements over a long period which are often ignored or, at best, very poorly understood by the taxpayers. The new rule would largely eliminate this problem, because only 2 percent of the existing home sales occur at prices above \$500,000. In order to have a gain of \$500,000, you would have to have a sale of substantially higher than that. The new rule would eliminate tax considerations and potential IRS conflicts and thus major recordkeeping burdens in almost all home transactions.

In addition, rollover rules have been criticized as forcing people to buy even more expensive housing, even if they do not need it or even if they do not really want to incur the debt load necessary to carry it. It also creates dilemmas for homeowners who relocate from high cost areas to lower cost housing areas.

Under the new proposal, housing decisions would be based on family needs, not on the Tax Code. This is a good policy. A family could still trade up, but it could also move down to smaller or less

expensive homes when no longer needed. We also view home equity as a principal source of saving and a safety net for most Americans. The new proposal would allow most people to realize all of the benefit of that saving. This may be important for families in reduced circumstances who are forced to sell a home due to lost employment or medical emergencies. Such families would not need to incur a tax cost if they sold their homes at a time of greatest need and decided to rent for awhile rather than reinvest.

Even though the National Association of Realtors supports the proposed residential exclusion, we do not believe it can substitute in any way for an across-the-board capital gains tax cut. The commercial investment industry and a host of individual investors and owners as well firmly and unequivocally support an across-the-board capital gains tax cut with at least two criteria: Number one, that the rate cut be substantial enough to be a meaningful incentive and number two, that it apply equally among all types of capital assets. The equal application of capital gains treatment is especially critical to owners of real estate. For some time it has been rumored, and we even had a discussion on this in the previous testimony, that a final capital gains bill would include adverse changes to rules for depreciation recapture. Now, my staff just pointed out to me that we do not understand that H.R. 14 does not have depreciation recapture changes, even though the previous panel said so, and we think they may have misunderstood the question, Mr. Chairman, but maybe we misread the bill.

But in any case, there have been discussions that the reduction of taxable basis due to straight line depreciation will not receive the full benefit of capital gains tax reduction. The real estate industry vigorously opposes any proposal that would adversely change depreciation recapture rules. Real estate is intrinsically a wasting asset which, due to natural deterioration, wear and tear from use and obsolescence, does not, unlike wine or cheese or art, gain value through use or through time lapses. Straight-line depreciation is a time-honored, fair, and reasonable allowance for this reasonable effect. Increases in the price of real estate result from inflation or extrinsic economic factors which are treated as capital gains as relates to all other capital assets.

Again, real estate supports a broad-based capital gains tax reduction but opposes any change to current law on depreciation recapture which we believe would put real estate on an unlevel playingfield in relation to other types of capital assets. One of the benefits of a capital gains rate cut is that it would produce an unlocking of assets as taxpayers rearrange their portfolios to release gain and to redeploy their capital to maximize return. Data released on March 12, 1997, by the Joint Committee on Taxation illustrates vividly just how locked in the real estate industry has become. These data measure reported capital gains transactions for all asset types. The data show that between 1989 and 1994, both the number of real estate sales transactions and the dollar volume as a percentage of total capital gains transactions declined tenfold.

Obviously, then, real estate markets seem frozen, and investor assets are locked in. Additionally, a chart presented at the end of this statement illustrates what the value of \$1 invested in real estate and in stock in 1986 would be worth today. The chart also

plots inflation during that period. Real estate prices have not even kept up with inflation, while the value of stocks has soared 400 percent. Real estate markets are healthier today than they were 5 years ago, but price appreciation has not been a hallmark of real estate investments since the 1986 Tax Reform Act.

These data help substantiate another fact about the real estate market: Price Waterhouse has studied commercial real estate sales since 1985 and reports that during the period from 1985 to 1996, 60 percent of those sales occurred at prices that were below the original purchase price. If the proposed depreciation recapture proposal were to be enacted, any property sold below purchase price would not experience any benefits of the capital gains cut. What does that mean? It means that if real estate receives fewer benefits from a capital gains cut relative to assets, there would be little or no unlocking of real estate investment and no new jobs created. No one can predict just how much unlocking would occur after the capital gains cut; however, from my experience, buildings are often upgraded after a sale. For every \$1 million spent in upgrades, 27 jobs annually are created. Using Department of Commerce data, we can speculate that the sale and upgrade of even 2,000 buildings nationally might create as many as 300,000 annual jobs.

In closing, we urge you to recognize the unique features of residential and commercial real estate. We urge you to adopt President Clinton's simplification proposal for the treatment of the sale of a principal residence, but we also urge a broad-based capital gains cut as critical for growth and jobs creation. It must apply equally to all assets. There is no reason to penalize real estate investors, owners and developers by changing recapture rules and robbing the real estate industry of an equal opportunity to continue to improve itself.

Thank you very much.

[The prepared statement and attachments follow:]

Statement of Richard Woodbury, President, Woodbury Corp., Salt Lake City, Utah; on Behalf of National Association of Realtors

The National Association of Realtors (NAR) appreciates the opportunity to testify concerning President Clinton's Fiscal Year 1998 Budget. This statement is presented on behalf of NAR's approximately 720,000 members. NAR represents virtually every facet of the real estate industry, including residential and commercial Realtor brokers and salespersons, developers, counselors, appraisers and property managers.

Real estate contributes about 16% of the goods and services that comprise our national economy. The industry has repeatedly demonstrated its capacity to lead the nation out of recession into economic recovery and growth. NAR supported the 1995 Contract With America provisions that would have reduced the tax rate on capital gains, recognized capital losses on the sale of a principal residence, indexed the cost basis of capital assets for inflation, permitted first-time home buyers to make penalty-free withdrawals from their Individual Retirement Accounts (IRAs), and increased the amount of the unified gift and estate tax credit. Unfortunately, President Clinton vetoed these important measures. We believe that his veto was detrimental to our members, and, moreover, that it had the effect of keeping many Americans locked into investments, and barred them from rearranging their portfolios to make the most productive use of their savings and their real estate holdings.

CAPITAL GAINS AND REAL ESTATE

NAR enthusiastically and actively supports all efforts to restore a meaningful capital gains differential. An exclusion and indexing are both important elements of a

differential, and we fully support both approaches. NAR supports S. 66, a bill introduced in the Senate by Senators Hatch (R-UT) and Lieberman (D-CT).

NAR would not object to an approach such as that included in S. 306, offered by Senator Wendell Ford (D-KY), and its companion bill, introduced in the House by Mr. Bentsen (D-TX). This approach would create a sliding scale capital gains tax rate. The rate for an asset held for one year would be 28%. The rate would be reduced by 2 percentage points for each succeeding year, down to a minimum rate of 14% for an asset held 8 years or more.

One of the things that we know about American is that they buy real estate. Generally, they buy as much real estate as they can afford. They buy homes, condos, cottages at the lake, hunting lodges, speculative parcels, a safe new home for mother and farms and ranches.

The incidence of the ownership of real estate is more widespread than one might expect. Federal Reserve data in the Survey of Consumer Finances show a remarkably high incidence of ownership of real estate by all individuals, and especially in income classes below \$50,000. The 1992 Survey shows that 63.8% of all families own a principal residence, and that 20% of all families own investment real estate. Among families with \$25,000-\$50,000 of income, 69% own a home, and a surprising 20% also own investment real estate. Among families in the \$50,000-\$100,000 income category, 85% own their home, and 30% own investment real estate.

The reasons for ownership are varied, and some of those reasons, we fully admit, are likely to be influenced by the tax effects of ownership. The important fact to note is that nonowner occupied real estate is more widely held than CDS, mutual funds, or stocks and bonds. Since real estate is so widely held, the markets for it are large and diverse. (Source: 1992 Survey of Consumer Finances, Federal Reserve Bulletin, Oct., 1994.) We strongly believe that the power of those markets can be augmented through the unlocking power of reduced capital gains taxes.

\$500,000 EXCLUSION ON SALE OF A PRINCIPAL RESIDENCE

President Clinton has proposed that taxpayers filing a joint return be permitted to exclude up to \$500,000 of gain (\$250,000 on a single return) on the sale of a principal residence. Owners qualify if the home has been used as a principal residence for two of the five previous years. Gain in excess of these amounts will be taxable at capital gains rates. Thus, a homeowner who filed a joint return and realized a gain of \$600,000 would receive \$500,000 tax-free, and \$100,000 of gain would be taxable at capital gains rates.

Under current law, the so-called "rollover" or deferred gain rules of Internal Revenue Code Section 1034 govern transactions involving the sale or exchange of a principal residence. Under the rollover rules, a taxpayer may exclude all gain on the sale of a personal residence from taxation, so long as the proceeds of the sale are reinvested in a home of the same or greater value. Each time a homeowner sells and reinvests, he/she is required to calculate the deferred gain, and make an adjustment to the purchase price of the new home to reflect the deferred gain in the tax basis of the home. In addition, the tax basis must be adjusted by the cost of any improvements that are made to the home. The taxpayer is required, for this purpose, to differentiate between repairs and improvements. Over the course of a lifetime, all this record keeping becomes subject to error, omission, and misunderstanding. In addition, the documentation becomes burdensome to maintain over the course of a lifetime. Not surprisingly, the IRS has indicated that taxpayer compliance with these requirements is low.

The rollover rules of current law have also been criticized for their impact on housing decisions. Critics have alleged that current law forces people to over-consume housing. Stated another way, the rules have the effect of forcing people to buy ever more expensive housing, even though they might not need it, and even though they may not want to incur the debt load needed to carry it. In addition, homeowners who relocate from high housing cost areas are perceived as driving up the cost of housing when they relocate to lower cost areas.

As homeowners grow older, they currently have the option to make a once-in-a-lifetime exclusion of up to \$125,000 of gain on the sale of their residence at age 55 or older. While this provision enjoys a broad base of support, it has been criticized because it applies only once, and because spouses who take the exclusion and are subsequently widowed are not permitted to use the exclusion again, even if the individual remarries someone who has never used the exclusion.

Now, President Clinton has proposed replacing the rollover and \$125,000 exclusion rules with a single \$500,000/\$250,000 exclusion that may be used as often as once every two years by homeowners of any age. NAR supports this proposal. First, it is an exceptional simplification of current law. In fact, we believe that it merits

support for this reason alone. Next, this is the ultimate "Get the IRS out of your life" proposal. Only a very small number of transactions annually will be taxable, so nearly all taxpayers will be relieved of the burdensome record keeping requirements of current law. In addition, this proposal preserves the savings value of the home. For most individuals, their home is the primary source of savings. Finally, the proposal has the great advantage of allowing individuals to make their housing decisions based on their circumstances, and not on the basis of the tax code. For the first time, the proposal would allow individuals to trade up, stay in roughly the same circumstances, or trade to a smaller and/or less expensive home. This is of critical importance to boomers and to empty-nesters who wish to change the configuration of their savings and housing arrangements.

Today, less than two percent of all existing home sales occur at price levels above \$500,000. Thus, in order for the gain to exceed \$500,000, the sales price will generally be substantially higher than the \$500,000 amount. The practical effect of this provision is to provide substantial record keeping and simplification relief to all but a very small number of taxpayers. Table I (attached) illustrates the volume of sales in different price categories nationally and regionally.

NAR commends the Administration for developing this remarkable simplification proposal. We view it principally as a simplification provision that happens to fall within the capital gains regime. We view it as a proposal that is desirable and supportable on its own merits as a simplification. We do not view it as a substitute for a broad-based capital gains reduction, and we believe it should be evaluated as separate from that debate.

LOSS ON SALE OF A PRINCIPAL RESIDENCE

The early 1980's saw the beginning of a phenomenon that came to be known as "rolling recessions," in which different regions of the country experienced recessions, even though the national economy was performing reasonably well. This phenomenon was accompanied by a circumstance that had not occurred widely during the entire post-World War II period. For the first time, homeowners in these regions experienced losses on the sales of their personal residences. Over the last 15 years, this situation has occurred in regions as diverse as the oil belt, the Rocky Mountain states, New England and, most recently, California (and southern California in particular).

Since the purchase of a home has generally been considered a personal expenditure, losses on the sale of a personal residence have not been recognized for tax purposes. Chairman Archer has sought for many years to ameliorate this circumstance as a matter of fairness. After all, a home is generally the greatest source of individual savings. Taxpayers who are in the difficult position of incurring a loss on that sale are often in an economically vulnerable posture. In 1995, the Chairman proposed and Congress passed provisions that allowed these taxpayers to receive capital loss treatment if their home sold at a loss. Earlier versions of a relief provision allowed a basis adjustment at the time of purchase of a replacement residence. NAR supports either method of providing relief in these circumstances.

NAR wishes to bring the Committee's attention a situation that is becoming increasingly common in areas where the market value of housing is declining. In many circumstances in some regional markets, homeowners are found to be "under water" or "upside down" on their mortgages: they owe more on the mortgage than they can realize on the sale of a principal residence. First-time homeowners who have purchased under low down payment programs are especially vulnerable. If an individual purchases a home with a 3%-5% down payment, and the market value declines by 10%, then the individual is technically "under water." If those individuals were forced to sell, they could easily come out of the transaction owing more than they would realize. An example can illustrate this problem.

Family A purchases a home under a low down payment program that requires only a 3% down payment. The purchase is for \$100,000, with \$3,000 down and mortgage indebtedness of \$97,000. (This configuration is often typical of VA and FHA mortgages.) After a few years of ownership, A must sell the home. At the time of the sale, the outstanding mortgage is \$92,000. A is able to realize only \$89,500 on the sale. A must pay closing costs and commissions, even though there is not enough cash to satisfy the mortgage or to make these payments. A successfully works out an arrangement with the lender in which A will pay \$88,000 on the note, and be forgiven \$4,000 of the debt. Thus, A has a loss on the sale of \$10,500, and at the same time has incurred a tax liability on the \$4,000 of forgiven debt.

This situation occurs in about 3% of the sales currently being closed in California. It can even occur, in some locations, in situations where the homeowner has made down payments of 10% or more. It defies logic that the homeowner would incur a

loss, and at the same time generate a tax liability. Thus, NAR believes that the loss on sale provisions should also address this circumstance. Since the loss on sale provisions are based on fairness and equity, it seems that this discharge of indebtedness problem should be dealt with in the same context.

BROAD-BASED CAPITAL GAINS CUTS

The capital gains issues that affect residential real estate are substantially different from those that affect commercial and investment real estate. Even after the \$500,000 exclusion, loss on sale and discharge of indebtedness provisions are favorably resolved, the more fundamental issue of capital gains taxes for all capital assets, not just real estate, will linger.

Before its repeal in 1986, the capital gains exclusion operated as a sort of rough justice to give taxpayers some incentive to hold property for the long haul, while giving an imprecise recognition to the effects of inflation on an investment. Real estate tends to be a very illiquid investment, so it was particularly important to the holders of real estate that some means of mitigating the impact of inflation would be available. The repeal of the capital gains exclusion in 1986 destroyed even that imprecise mechanism. Lower tax rates simply did not overcome the impact of removing the exclusion.

The dirty little secret of current law is that middle income Americans who have the good fortune to realize a capital gain are not treated as favorably as higher income individuals. The effect of the higher tax rates enacted in 1993 was that one class of upper-income taxpayers enjoys a tax benefit equivalent to a 30% exclusion. Individuals in the 15% and 28% tax brackets pay that rate on the full amount of any capital gain they might realize. By contrast, individuals in the 31%, 36% and 39.6% brackets pay no more than 28% tax rates on the full amount of any of their capital gains. For individuals in the 39.6% bracket, this rate differential is the equivalent of a 30% exclusion.

A significant volume of capital gains transactions occurs for individuals in the 15% and 28% brackets, which reach to about \$85,000 on a joint return. This income group has the largest number of capital gains transactions by volume, even though the dollar amount is relatively small. Many of those taxpayers will have only a limited number of capital gains transactions in a lifetime, yet their limited number of assets is presently taxed less advantageously than the larger, diversified portfolio of an upper income individual. A broad-based capital gains cut, accomplished by an exclusion or a sliding scale rate cut, and combined with indexing, would redress the fundamental unfairness of having two classes of taxpayers—those with a capital gains differential, and those without a differential.

NAR fully subscribes to the view of capital gains advocates that a cut in capital gains tax rates would unlock significant amounts of investment that would be plowed back into ever-more productive uses. We cannot quantify what the volume of new transactions would be. Measuring pent-up demand is all but impossible, because there is no baseline that can be fixed for transactions that don't occur. Every Realtor we meet, however, has stories to tell about properties that would have sold, except that the tax beating of current law would be too great. Realtors have hardship stories, as well, about people in reduced circumstances forced to sell their assets, only to face large tax bills.

Indexing—NAR supports proposals that permit indexing on the sale of assets. While many of our members would hope to have a look-back provision, we acknowledge that such a provision would be costly to enact, and difficult to administer. We take no position on the choice of index used, but simply urge that the compliance provisions associated with administering an indexing scheme be as simple as possible. We look forward to working with the IRS to develop record keeping and compliance programs that will be easily understood by taxpayers. Taxpayers will need some education about the record keeping challenges posed by an indexing scheme, and we are committed to doing our part in assisting in that effort.

DEPRECIATION RECAPTURE

For more than a year, rumors have circulated that a capital gains cut would create new rules for depreciation recapture. This rumor was confirmed in a Wall Street Journal story on February 14, 1997, noting that Joint Tax Committee Chief of Staff Ken Kies was urging that previously-allowed depreciation deductions be recaptured and taxed at 28%, with any remaining gain taxed at the new, reduced rate. His rationale is that current law, which permits capital gains treatment of depreciation recapture, creates unfair advantages for real estate and could lead to tax sheltering. We reject this view, and further urge that current law as provided in Code Section 1250 be retained.

After the Tax Reform Act of 1986, commercial real estate values plummeted. Since 1990, that market has been recapitalized. Between 1990 and the present, however, there has been very little, if any, appreciation for commercial real estate. According to analysis performed by Price Waterhouse, about 60 percent of all commercial real estate transactions between 1985 and 1995 have occurred at a price that is less than the original purchase price. If the depreciation recapture rate were to remain at 28% or more, the owners of those properties would receive no benefit whatever from the capital gains cut. Thus, they would be at a disadvantage relative to other assets that receive the full benefit of rate reduction and they would not, at present, be inclined to sell or improve those properties.

Even today, real estate assets are locked in, as owners are reluctant to sell and pay the high taxes associated with a real estate transaction. Data released on March 12, 1997 by the Joint Committee on Taxation illustrate vividly just how locked in the real estate industry has become. These data measure reported capital gains transactions. Between 1989 and 1994, both the number of real estate sales transactions and the dollar volume of those transactions declined tenfold. If the full benefits of a capital gains rate cut are not extended to the real estate industry and investors because of changes to recapture, no unlocking of assets and capital would occur, and no new jobs would be created.

We also note that owners who invested for long holding periods would be seriously disadvantaged, because they would bear disproportionate recapture burdens. Holding the recapture rate at 28 percent has the effect of raising the tax rate on the entire investment, no matter how long it is held. Where the asset has been held for long periods of time, the recapture amount could be quite large as a proportion of the total amount of gain in excess of adjusted basis. The greater the proportion of recapture to gain, the more the tax rate would be distorted (and increased relative to other assets) under the rumored proposal.

A fundamental principle in the past 20 years of capital gains debates has been that all capital assets should be treated in the same manner, and that no industry or class of assets should be singled out for discriminatory treatment. We believe that the proposed recapture regime does not satisfy this standard. We believe that it discriminates against real estate. Given the performance of real estate markets in recent years, we believe it would be singularly unfair to impose real estate-specific taxes on an industry that is still somewhat fragile.

Table 2 illustrates that very fragile condition and compares it with the price volatility in the stock market, as measured by the Dow Jones and Standard Poor's indices. The chart shows the value of a dollar invested in real estate in 1985, and compares it with the value of a dollar invested in securities. The chart refers to price effects only, and not to rate of return. What it does illustrate, however, is the extraordinary surge in the market value of securities over that period, compared with a very flat real estate market. Notably, this chart is not adjusted for inflation. Thus, it shows that a dollar invested in real estate in 1985 is worth less than a dollar if the property sold today, while a dollar invested in the stock market in 1985 would yield about \$4 today. If the chart were adjusted for inflation, the real estate price in 1996 would be even less than shown on the graph.

Because of the continuing interest in simplification and tax reform, we feel obligated to note that the proposed recapture regime would be very complex. Even as presently drafted, recapture is, at best, very complex. The proposed regime would graft yet another layer of complication onto this already-burdensome set of rules. We believe that it is inappropriate to advocate complex solutions at this time, particularly when those complexities do not improve the fairness of the code or enhance the performance of an individual's business or the national economy.

We therefore believe that the proposed recapture regime would achieve none of the unlocking of gain that is envisioned by capital gains advocates. In many markets, there has been little appreciation in real estate for several years. Accordingly, individuals who sold properties under the proposed regime would find that much, if not all, of their gain was attributable to depreciation recapture, and not to appreciation. Thus, a taxpayer who experienced minimal appreciation would not be any better off than under current law, while the owners of appreciated non-real estate capital assets would receive far more benefit from a capital gains tax rate reduction. Only a scheme that retains existing Section 1250 recapture taxes would keep all asset owners on a level playing field.

INDIVIDUAL RETIREMENT ACCOUNTS

President Clinton, Mr. Thomas and Chairman Roth all have all offered proposals to expand the classes of taxpayers eligible to make tax-deductible contributions to an Individual Retirement Account (IRA) and/or to a new tax-deferred "back-loaded"

savings vehicle. NAR supports these proposals, because they expand the savings pool. Expanded national savings should have beneficial effects in keeping interest rates low. No sector of the economy is more sensitive to interest rates than housing, and so we support these endeavors.

In the context of improved and expanded IRA provisions, we urge that the Committee include a provision that has passed the House at least 3 times this decade, twice in 1992 and again in 1995. This provision permits a penalty-free withdrawal from an IRA or 401(k) plan for use as a down payment by a first-time home buyer. Significantly, it also permits a parent or grandparent to make penalty-free withdrawals to assist a child or grandchild in making a down payment for a first-time home purchase. NAR actively advocated this approach in earlier years, and strongly believes that the "parent and grandparent pass-through" is crucial to making any new IRA plan a genuine vehicle for advancing first-time home purchases. NAR's research shows that young people are increasingly relying on family members to fund some portion of their home purchase down payments. Accordingly, this parent/grandparent feature of the proposal is a critical feature of the efforts to permit IRA withdrawals to further home ownership.

Table 1. Total Existing Single Family Home Sales by Price Class—1996

Region	Price Class	No. of Sales	Percent of Sales
United States	\$0 to \$250,000	3,627,142	88.77
	\$250,000 to \$500,000	377,955	9.25
	Above \$500,000	\$80,903	1.98
Total		4,086,000D	
Northeast	\$0 to \$250,000	513,315	84.15
	\$250,000 to \$500,000	78,873	12.93
	Above \$500,00	17,812	2.92
Total		610,000	
Midwest	\$0 to \$250,000	992,242	94.77
	\$250,000 to \$500,000	49,628	4.74
	Above \$500,00	5,130	0.49
Total		1,047,000	
South	\$0 to \$250,000	1,393,659	91.93
	\$250,000 to \$500,000	103,088	6.8
	Above \$500,00	19,253	1.27
Total		1,516,000	
West	\$0 to \$250,000	725,314	79.53
	\$250,000 to \$500,000	147,653	16.19
	Above \$500,00	39,034	4.28
Total		912,000	

Chairman ARCHER. Thank you, Mr. Woodbury.

Our last witness for this panel is Thomas Wiggans, and if you will identify yourself for the record, we will be pleased to receive your testimony.

STATEMENT OF TOM WIGGANS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CONNECTIVE THERAPEUTICS, INC., PALO ALTO, CALIFORNIA; ON BEHALF OF BIOTECHNOLOGY INDUSTRY ORGANIZATION

Mr. WIGGANS. Thank you, Mr. Chairman. My name is Thomas Wiggans, and I am the president and chief executive officer of Connective Therapeutics, which is a biotechnology company based in Palo Alto, California. I appreciate this opportunity to discuss the merits of capital gains incentives on behalf of the 700-member companies and organizations of the Biotechnology Industry Organization, and a coalition of eight groups that are representing more than 15,000 entrepreneurial firms in all 50 States.

I suppose you would expect an entrepreneur to cut to the bottom line, and that is what I am going to do. We support enactment of an across-the-board capital gains incentive accompanied by much needed improvements to the current law providing incentives for direct investment in stocks of emerging companies. In particular, H.R. 420, the Matsui-English bill and H.R. 1033, the Dunn bill, seem to be particularly well crafted, appropriate, and elegant solutions to this issue.

So, that is who I represent and what I represent. What I would like to do for just a couple of minutes is tell you who I am, where I come from, and what people like me do out there. I have heard a lot of comments this morning about “dynamic” versus “static” scoring. I will tell you about what I believe is a very dynamic segment of our economy.

I am an entrepreneur. I run a company that has been funded, so far, with \$50 million in investor capital, starting with venture capital investment, patient capital that is held for years and years. We are using that investment to develop products to treat serious skin and connective tissue diseases. I work with remarkable technology, brilliant scientists, extremely committed employees and investors who are willing to invest and lock up their investment for years at a time.

Our company is a young biotechnology company. One of our first products has shown great promise in the treatment of a condition called scleroderma. It is a very serious, debilitating, untreatable condition that affects women, has a 5-year mortality rate of 50 percent and, as I mentioned, is untreatable. So, while I am here in a tax forum, let me remind you, and try to emphasize, what freeing up capital to firms like mine ultimately results in: New therapies for very sick patients and new job creation.

Connective Therapeutics has 60 employees, up from zero 4 years ago when it was founded. We occupy a facility in Palo Alto that previously housed a pioneering biotechnology company developing cancer therapies. It subsequently became successful and moved out into larger facilities now employing hundreds of people. We are around the corner from a small building with a simple plaque on it that indicates it is the site where the first integrated circuit was developed. So, I come from a part of the country where new technologies and new medical advances arise on a daily basis.

I think all of us out there are living the great American dream. We are combining great ideas with talented people; throw in a little terror associated with the possibility of total failure, and the exhilaration of developing therapies for people who have no hope, and you have an equation that works. Where I come from, there is no shortage of great ideas; there is no shortage of great science, remarkable vision, or limitless energy. Companies rely on equity and sweat equity to achieve their goals. There is no shortage of sweat equity; however, equity capital is the single, most precious, limiting factor to our success.

Capital to fund ideas has made America great; capital to fund my company has brought exciting new therapies to patients, and unleashing capital will further turbocharge America’s entrepreneurial engine. We ask you to give us the tools we need to form new investment and bring these therapies forward.

From where I come from, the call here in Washington for capital gains incentives seems to have reached a deafening roar. But for the entrepreneurs I work with in Silicon Valley and for entrepreneurs throughout America, it is not the call, but who answers the call; it is who steps up and gets the job done. What I am here to ask you to do is step up and get the job done and pass these incentives to release capital and fund companies like mine.

Thank you very much.

[The prepared statement and attachments follow:]

Statement of Tom Wiggins, President and Chief Executive Officer, Connective Therapeutics, Inc., Palo Alto, California; on Behalf of Biotechnology Industry Organization

Mr. Chairman and Members of the Committee:

My name is Tom Wiggins and I am President and CEO of Connective Therapeutics, a biotechnology company based in Palo Alto, California that develops products to treat diseases of the skin and connective tissues. I appreciate this opportunity to discuss the merits of capital gains relief for venture capital investments.

I am proud to be able to speak to you as an entrepreneur whose firm has been funded by \$50 million in investor capital. Without investors taking risks by buying stock in firms like mine, much life-saving biomedical research will go unfunded, and America's technological leadership will falter.

My firm is a member of the Biotechnology Industry Organization (BIO), an association of 700 biotechnology companies. I am honored to say that the capital gains incentives for entrepreneurs and emerging companies of the type I will describe here have also been endorsed by the Alliance for Business Investment (an association of money-center commercial banking corporations whose venture capital subsidiaries fund small and medium-sized emerging companies), American Entrepreneurs For Economic Growth, American Electronics Association, Council of Growing Companies, National Association of Small Business Investment Companies, National Venture Capital Association, Software Publishers Association, and the American Bankers Association. These organizations together represent over 15,000 entrepreneurial firms in all 50 states.

RECOMMENDATIONS FOR CAPITAL GAINS RELIEF

As all entrepreneurs must do, let me start with the bottom line: we support enactment of an across-the-board capital gains incentive accompanied by needed improvements to the current law incentive targeted at direct investments in the stock of emerging companies. The 1995 Balanced Budget Act included a two-tiered capital gains incentive similar to what we propose here. This Committee will consider several bills in the course of your deliberations on capital gains relief. We especially call to your attention H.R. 420, introduced by Representatives Bob Matsui, Phil English, and Jim McCrery, and H.R. 1033, recently introduced by Representative Jennifer Dunn.

CONNECTIVE THERAPEUTICS

Connective Therapeutics is a young biotechnology company whose first product is being tested for the treatment of a very serious, untreatable disease. This product is a compound that did not show clinical effectiveness in its first medical indication in research by a major pharmaceutical company, but it has now been shown to hold great promise for the treatment of scleroderma, a rare, debilitating and untreatable condition affecting skin connective tissue and a condition which almost always continues to worsen and result in death.

Scleroderma primarily affects women between the ages of 20 and 50, and the five year mortality rate is 50 percent. We also are researching products to treat other progressive, often fatal fibrosis of the lungs, kidneys, and liver. We recently completed our first clinical trial involving scleroderma patients.

The original developer of this compound had the foresight to make it available to my new company. However, it was investors who were willing to put their capital at risk who allowed our company to begin testing the compound in scleroderma patients. What we have at my company is an exciting story about the entrepreneurial biotechnology industry and the hope and risk associated with development of a breakthrough drug.

From 1992 to 1994 I served as Chief Operating Officer of CytoTherapeutics, a biotechnology company based in Providence, Rhode Island, which is developing cell transplantation technology for the treatment of serious central nervous system disorders, such as Parkinson's Disease and Alzheimer's Disease. I have a BS in Pharmacy from the University of Kansas and an MBA from Southern Methodist University.

CAPITAL FORMATION TO FUND RESEARCH

You need to understand one simple fact about the biotechnology industry: most of our firms fund research on deadly and disabling diseases from investor capital, not revenue. Without investors taking the risk of buying the stock of our companies, much of our vital research would end. Now you understand why our industry cares so much about capital gains incentives and about incentives for venture capital in particular.

Almost without exception, our industry cannot borrow capital. Our principal, and for most of us, our only source of capital is equity capital. This is why a capital gains incentive focused in part specifically on direct equity investments in stock is so exciting to us and to other entrepreneur-led industries.

It is also important to emphasize that capital gains taxes affect the value of founder's stock and employee stock options. They are direct equity investors in an entrepreneurial firm. Approximately 78 percent of biotechnology firms provide stock options to all of their employees. And we have such a young industry that many founders are still in charge. The leadership of founders and the talent of employees motivated by stock options are critical to innovations by entrepreneurial firms.

Bringing a biotech drug product to the market today is both a lengthy and expensive process. From the initial testing of the drug to final approval from the Food and Drug Administration can take 7-12 years, and this process can cost anywhere from \$150 to \$359 million. Both the length and cost of this process are a tremendous impediment for small biotechnology companies attempting to bring a product to the market. Patient capital is critical. Investors have already invested \$50 million in my company and they will have to wait several more years before we and they will know whether the products we have under development will generate a reasonable rate of return.

INTERNATIONAL COMPETITIVENESS AND FOREIGN COMPETITION

As is the case with many of the high-tech industries that I represent today, the United States currently has the dominant biotechnology industry when compared with any other country in the world. Precisely because the U.S. is preeminent in the field of biotechnology, it has become a target of other country's industrial policies. In 1991, the Office of Technology Assessment (OTA) found that Australia, Brazil, Denmark, France, South Korea and Taiwan (Republic of China) all had targeted biotechnology as an enabling technology. Furthermore, in 1984, the OTA identified Japan as the major potential competitor to the United States in biotechnology commercialization.¹ The Japanese government has aggressively helped fund and support the development of their private sector. For instance, they instituted a policy whereby existing drugs would have their prices lowered, while allowing premium prices for innovative or important new drugs, thus forcing companies to be innovative and to seek larger markets.²

The competitiveness of the U.S. biotechnology industry means that U.S. patients with rare deadly and disabling diseases have hope. It means that they can look to American biotech companies to develop the therapies and cures which will ease their suffering.

CAPITAL GAINS INCENTIVES

The entrepreneurial sector strongly endorses broad-based capital gains relief paired with a venture capital incentive. We believe that these two capital gains incentives are complementary and will ensure that venture capital is available for America's entrepreneurs and emerging companies. The 1995 Balanced Budget Act included a two-tiered capital gains incentive similar to what we propose here. This Committee will consider several bills in the course of your deliberations on capital gains relief. We especially call to your attention H.R. 420, introduced by Representa-

¹ U.S. Congress, Office of Technology Assessment, *Biotechnology in a Global Economy* 243 (October 1991).

² *Id.* at 244-245.

tives Bob Matsui, Phil English, and Jim McCrery, and H.R. 1033, recently introduced by Representative Jennifer Dunn.

Including a venture capital incentive recognizes that not all investments in capital assets are the same. Venture capital investments typically involve more risk, and potentially provide greater economic and social benefits, than other types of investments. Venture capital investors are more likely to lose some or all of their principal. Moreover, the holding periods for these investments tend to be quite long, stretching over several years at least. At the same time, venture capital investments can be the most productive, economically and socially, creating whole new industries and revolutionizing our standard of living.

THE EXISTING VENTURE CAPITAL GAINS INCENTIVE DOES NOT WORK AS INTENDED

In 1993, Congress enacted Section 1202 of the Internal Revenue Code in an effort to provide an added capital gains incentive for investments in qualifying small business stock. Unfortunately, this provision as finally enacted ended up with several limitations on its usefulness, and thus it is not working as intended. Nevertheless, the concept of an incentive for new, direct, long-term investments in small company stock is sound.

Section 1202 provides a 50-percent exclusion for gain from the sale of qualified small business stock. To qualify, stock must be acquired at original issuance and held for 5 years. The principal limitations in Section 1202 include a capitalization limit of \$50 million not indexed for inflation; availability of the incentive only to individual taxpayers; a per taxpayer limit of 10 times the basis of the investment or \$10 million (whichever is greater); an exemption for only half of the excluded gains from the alternative minimum tax (AMT); a required five year holding period; and substantially modified definitions dealing with working capital requirements.

Section 1202, because of the limitations it contains, has been completely ineffective in forming capital for entrepreneurs and emerging companies. The working capital requirement definitions are unworkable. The AMT provision is unduly burdensome, as the AMT recaptures the capital gains tax benefits and for many taxpayers cancels out any incentive to make the investments. Corporations, as well as individuals, are a vital source of venture capital. It is essential that incentives for further growth in new businesses reduce taxes on corporate investments in the same manner as on investments by individuals.

PROPOSED IMPROVEMENTS TO SECTION 1202

The Balanced Budget Act of 1995, vetoed by the President, would have provided a number of needed improvements to Section 1202. This year, several measures have again been proposed to deal with the problems in existing law.

H.R. 420 would modify Section 1202 by increasing the exclusion to 75 percent for direct investments held for 3 years (instead of 5 under current law). Favorable treatment would extend to the stock of a corporation with capitalization of up to \$100 million (increased from \$50 million today). Section 1202 investments would be exempt from the AMT, which is critical to attract the type of investments entrepreneurs need. H.R. 420 would permit corporations to invest in qualified small business stock. Finally, it includes an incentive for investors to rollover their gains into another qualified incentive. H.R. 1033 contains substantially the same provisions as H.R. 420.

Because Section 1202 is current law, the revenue cost for these proposed amendments is modest. Amendments similar to the ones we propose here (found in S. 959) were found in 1995 by the Joint Tax Committee to cost \$200 million over five years, \$400 over seven years, and \$700 million over ten years. This means that amending Section 1202 to make it an effective incentive is an extraordinarily cost effective proposal.

BENEFITS OF A WORKABLE VENTURE CAPITAL INCENTIVE

Entrepreneurs create jobs and capture markets. The electronics, biotechnology, and other high technology industries have changed our economy and changed our lives. The venture capital incentive in H.R. 420 applies to a variety of businesses which raise capital with stock offerings, and it will be utilized by high technology firms that are capital and research intensive and have no other source of capital available, as well as by other dynamic venture-backed businesses that create jobs all across the country.

The role of entrepreneurs in creating jobs and economic growth in our economy is documented in a research analysis I have appended to my testimony. Let me cite just a few of the findings:

- Comparison to Fortune 500: Between 1980 and 1990 U.S. private sector employment grew by 19 million jobs, but employment in the Fortune 500 firms dropped by 3 million jobs. This means that employment in the non-Fortune 500 firms had to grow by 22 million jobs to make up for the loss with the larger firms.

- The Inc. annual survey of the 100 fastest growing small public companies documented the same point. The median five year sales growth for the companies was an astounding 2,239% and the median sales had grown from \$1,796,000 to \$47,144,000 in five years. The median number of employees had risen from 31 to 260 in five years and the median productivity of the employees had risen from \$52,289 to \$167,310 in five years. The top ranked firm, AmeriData Technologies, sells computers and integrates computer systems and its sales had grown 135,647% in the past five years.

- Venture Capital-Backed Firms: Venture capital-backed firms are prolific creators of jobs. Venture-backed firms increased employment by an average of 20% per year from 1990 to 1994 at a time when Fortune 500 firms lost nearly 1% of their employees per year. By the time a venture-backed firm is six years old, it typically employs 282 people. The percentage of these jobs taken by engineers, scientists, and managers is 61%, four times the percentage of the workforce as a whole.

- The staggering research intensity of high technology firms is confirmed each year in the *Business Week* survey on Research and Development expenditures. The survey measures the percentage of increase in absolute terms and also the research intensity as a percentage of sales or on a per employee basis. The 1995 survey finds a 14% increase in R and D by electrical and electronics firms, which spent \$9.6 billion on research, 5.7% as a percentage of sales, and \$8,257 per employee. Office equipment and sales firms spent \$15,898 per employee on research, health care firms spent \$18,451 per employee, and chemicals spent \$10,289 per employee. The all industry averages are 4% increases, 3.5% as a percentage of sales, and \$7,651 per employee.

- Staples, the office supply superstore, is today the country's biggest retailer of office supplies. Sales in 1995 were \$3.1 billion; net income was \$73.7 million. By the end of 1995 it employed 22,000 people and expected to hire an additional 10,000 in 1996. It paid \$44.5 million in state and federal income tax in 1996. In 1987 Staples had one store in Brighton, Massachusetts, and needed capital to expand. A small business investment company was willing to step in and provide the needed equity financing, \$1.5 million.

These stunning facts and those in the appendix demonstrate the need to enact a capital gains incentive including improvements to the 1993 venture capital incentive. Entrepreneurial firms are the ones which can dramatically change our whole health care system, clean up our environment, link us in international telecommunication networks, and increase our capacity to understand our world. The firms are founded by dreamers, adventurers, and risk-takers who embody the best we have to offer in our free-enterprise economy.

THE NEED FOR CAPITAL GAINS RELIEF

We support a two-tiered incentive. A broad-based capital gains incentive that applies to currently held assets is vital to unlocking the current ownership of capital assets. Reducing the penalty for sale of these assets will free up capital to be invested in more productive investments. In addition, many other sectors of the economy do not rely on direct equity investments and there is a powerful rationale for providing a capital gains incentive for these investments.

America's entrepreneurs rely on equity investments to fund research and development. Most of them have no sales and, therefore, no ability to borrow funds. To raise capital they must issue stock, to angel investors, to venture capitalists, or to investors in public offerings. Capital raised from equity offerings does not involve carrying costs. It tends to be patient capital, precisely what struggling entrepreneurs need. This is exactly the type of capital formation covered by H.R. 420.

An incentive focused on direct purchases of stock provides an incentive for founders and company employees who acquire stock through the exercise of stock options. Founders and their employees take a major risk when they leave established firms to found start-ups. They often take a major cut in pay with the hope that the value of their stock will justify their decision. We must provide an incentive for outside investors, but it may be even more important to provide an incentive for founders and their employees. No one is more valuable to our economy than our entrepreneurs.

CONCLUSION

In conclusion, we support a broad-based reduction in capital gains taxes and we believe it should be paired with improvements to the targeted venture capital incentive in current law. We believe this combination will be the most cost-effective incentive for capital formation for entrepreneurs.

Thank you again for the opportunity to testify. I am happy to answer your questions.

Venture Capital Gains Incentive: H.R. 420, Matsui/English/McCrery

Enacted in 1993 Budget Reconciliation Bill:

- 50% capital gains exclusion for new investments—not sale of previously acquired assets—new investments made after effective date, August 1993
- only if investments made directly in stock—not secondary trading, founders stock, stock options, venture capital, public offerings, common, preferred, convertible preferred
- only if made in stock of a small corporation—defined as a corporation with \$50 million or less in capitalization—ceiling not indexed for inflation
- only if investment held for five years
- only if investment made by an individual taxpayer—not by a corporate taxpayer
- 50% of the excluded gains not covered by the Alternative Minimum Tax (AMT)
- limit on benefits per taxpayer of 10 times basis or \$10 million, whichever is greater
- technical problems—redemption of stock, spending speed-up provision

H.R. 420—Eight proposed amendments to incentive:

- (1) 75% capital gains exclusion—up from 50%
- only new investments—same
- only if direct investments—same
- only if investment in stock—same
- (2) only if investment held for three years—same (see rollover provision below)—reduction from five years
- (3) define small corporation as one with \$100 million in capitalization and index for inflation—up from \$50 million with no indexing
- (4) apply to corporate taxpayers—now only applies to individual taxpayers
- (5) 100% exemption from AMT—now 50% exemption
- (6) delete 10 times or \$10 million limitation
- (7) fix technical problems—modify redemption of stock, spending speed-up provision
- (8) add rollover provision—provide for a deferral of gains taxes for those who reinvest proceeds from sale of a qualified venture capital asset in another qualified venture capital asset

Summary of 1995 Balanced Budget Bill

Capital Gains Incentives (Conference Bill)

1. Broad-Based Capital Gains Tax Relief

1) Individual taxpayers would be allowed a deduction of 50 percent of any net capital gain for capital assets held for at least one year. The top effective tax rate on capital gains would thus be 19.8 percent. Gains rate of 7.5 percent for taxpayers in 15 percent tax bracket. Repeals current 28 percent capital gains maximum rate. Same as in House-passed bill, H.R. 1215, and S. 959.

2) Does not apply to sale of collectibles.

3) Applies to sale of previously acquired assets sold after the effective date of the incentive (unlocking effect) and to new investments held for at least one year.

3) Capital gains of corporate taxpayers would be subject to a maximum capital gains rate of 28 percent.

5) Indexing of the basis of capital assets is not included.

6) None of the deduction is included as a preference item in the Alternative Minimum Tax (AMT).

7) Gains provision would be effective for sales of capital assets held for at least one year after January 1, 1995.

2. Venture Capital Gains Incentive

1) Provides a maximum 14 percent venture capital incentive for investments in the stock of a small business held for at least five years. (Senate bill provided a 75% exclusion—a 9.9% rate)

2) Applies only to new investments made after August 10, 1993 (the original effective date for the venture capital incentive included in the 1993 Budget Reconciliation Act) and held for at least five years. (Does not reduce holding period to three years.)

3) Small business must have \$100 million or less in aggregate gross assets and stock must be purchased directly from the company (does not include secondary trading of stock).

4) Capital gains of corporate taxpayers would be subject to a maximum capital gains rate of 21 percent.

5) Indexing of the basis of capital assets is not included.

6) None of the deduction included as a preference item in the Alternative Minimum Tax (AMT).

7) Repeals and amends various restrictions in 1993 venture capital provision.

8) Does not include rollover provision from Senate bill.

Summary of 1995 Balance Budget Bill Capital Gains Incentives (Conference Bill)

Broad-Based Gains Incentive	Venture Capital Gains Incentive
Applies to investments in any capital asset	Applies to investments in stock of small corporation Includes both common or preferred stock issued by corporation Only purchases of stock directly from company—does not cover secondary trading Corporation must have \$100 million or less in aggregate gross assets
50% of gains not taxed (effective top tax rate of 19.8%). Must hold investment for at least one year	Sets 14% maximum gains rate (no use exclusion approach) Must hold investment for at least 5 years Applies to sale of assets acquired after August 10, 1993 (effective date for 1993 venture capital incentive)
Applies to sale of assets acquired before January 1, 1995, if held for at least one year (unlocking effect).	Does not apply to assets acquired before effective date
None of untaxed gains included in Alternative Minimum Tax. Individual and corporate investors covered	None of untaxed gains included in Alternative Minimum Tax Individual and corporate investors covered
Maximum corporate gains tax rate is 28%	Maximum corporate gains rate is 21% Does not include Senate rollover provision

Senate 75% Exclusion and Rollover Provision (Dropped in Conference)

The Senate budget bill in 1995 went to the conference with a venture capital incentive which was modified in the conference.

1. 75% Exclusion: Senate bill provided for a 75% capital gains exclusion for venture capital investments—contrasted with a 50% exclusion for non-venture capital investments.

The effective rates were 9.9% for venture capital investments and 19.8% for non-venture capital investments.

In the conference the 50% exclusion for non-venture capital investments was retained, but the 75% exclusion was modified to a 14% maximum rate.

One can set a capital gains incentive either as an exclusion or a maximum rate or both.

The 14% maximum rate provides only a 1% incentive to taxpayers in the 15% tax bracket. An exclusion is the better way to provide an incentive to these taxpayers.

2. Rollover Provision: The Senate bill provided that taxpayers which realized gains on a venture capital investment could defer paying tax on the gains if they rollover their investment over into another venture capital investment within a short period of time. This rollover provision then provided that the holding period on the next and subsequent venture capital investments would be one year, not five years.

This provision was dropped in the conference.

The provision provides an incentive for investors to keep their investments at work and not to divert them to non-venture capital investments.

3. Revenue Scores: The Hatch-Lieberman bill, on which the Senate bill was based, included a 75% exclusion, the rollover provision, a complete exemption from the AMT for both broad-based and venture capital investments, and it was scored as losing \$700 million over seven years. The rollover provision was scored as losing less than \$50 million over seven years.

Amendments to 1993 Venture Capital Incentive Included in H.R. 420

H.R. 420 amends Section 1202, the venture capital incentive enacted as part of the 1993 Budget Reconciliation Act, in the ways described below. With these amendments the incentive will be effective in forming capital for entrepreneurs.

The amendments do the following:

1. Capitalization Ceiling: increase the capitalization ceiling from \$50 million to \$100 million and index the ceiling for inflation (defines which companies stock qualifies for the gains incentive)—increasing ceiling includes stock offerings of more capital intensive companies
2. Corporate Taxpayers: apply venture capital incentive to corporate taxpayers—increases capital investments in small companies by corporate taxpayers
3. Holding Period: Reduces holding period from five to two years.
4. Per Taxpayer Benefits Limit: eliminate the 10 times or \$10 million per taxpayer limitation on benefits per gains realization—permits taxpayers to offset losses on risky investments with winners on others
5. Alternative Minimum Tax: exempt all of the excluded gains from the alternative minimum tax—avoids zero sum game of granting exclusion and then recapturing benefits of exclusion by AMT
6. Working Capital Rules: fix the working capital rules which require that 50% of the capital raised be expended within two years and bars companies from redeeming stock even if it is for a business purpose—companies which violate these rules invalidate any tax benefits for investors—rules have been unworkable rules and prevent any use of the 1993 incentive to form capital
7. Capital Gains Rollover: provide for a deferral of gains taxes (a rollover provision) for those who reinvest proceeds from sale of a qualified venture capital asset in another qualified venture capital asset—encourages investors to maintain commitment to venture capital investments
8. Exclusion Differential: increase capital gains exclusion from 50% to 75% (both individuals and corporations)—provides differential with broad-based capital gains exclusion.

Revenue Implications of Amendments: The Joint Committee on Taxation has ruled in 1995 that amendments similar to these (found in S. 959, Hatch-Lieberman bill) would lose the following amounts of revenue: \$200 million—over five years; \$400 million—over seven years; and \$700 million—over ten years.

**Role of Entrepreneurs in America's Economy (Excerpt from
"Entrepreneurs Agenda"³)**

FUNDAMENTAL AMERICAN VALUES

The role of entrepreneurs cannot be entirely described in economic terms. It is critical to understand that entrepreneurs epitomize the fundamental American values of the rights of the individual, freedom of speech and choice, democracy and restraints on bureaucracy and concentrations of power, and private ownership of property.

These are the values which have characterized America from its founding and define our values in relationship to the rest of the world. These are the values which characterize—and are championed by—entrepreneurs.

The Declaration of Independence states that all men have certain unalienable rights among which are life, liberty, and the pursuit of happiness. Among the grievances listed in the Declaration are the cutting off of our trade with all parts of the world and among the rights asserted were the rights to establish commerce.

Our country was founded to secure economic, not just political, freedom from England and the Constitution we adopted focuses on such commercial issues as regulating commerce and trade, regulating bankruptcies, coining money, fixing the standard of weights and measures, establishing post offices, and promoting the progress of science and useful arts with patents and copyrights.

We are the land of opportunity and there are no Americans which utilize these opportunities like entrepreneurs. Entrepreneurs see opportunities where others do not. They turn the opportunities into reality for themselves, their employees, their customers, and the society as a whole.

Those who champion change always meet resistance. They are confronted by skeptics, roadblocks, bureaucracies, defenders of the status quo, and hostility. But, they persevere and fashion a new reality. We can laugh at the initial thoughts of some of America's most successful entrepreneurs and scientists.

"The phonograph...is not of any commercial value." Thomas Edison, 1880.

"There is no likelihood that man can ever tap the power of the atom." Robert Millikan, Nobel Prize winner in physics, 1920.

"There is no reason for any individual to have a computer in their home." Ken Olsen, President of Digital Equipment Corporation, 1977.

"I think there is a world market for about five computers." Thomas J. Watson, Chairman of IBM, 1943.

"It is an idle idea, to imagine that...automobiles will take the place of railways in the long distance movement of...passengers." American Road Congress, 1913.⁴

Fortunately, these entrepreneurs and many others are capable of brilliant insights and have a profound capacity to learn from their mistakes and preserve.

Entrepreneurs are often unconventional, idiosyncratic, restless, even odd. They have passion and a vision of the way the world ought to be. Entrepreneurs thrive in ambiguous environments.⁵

Fundamental to the growth of a free and open society is the need for an informed electorate and freedom of thought and expression. Entrepreneurship is the embodiment of those democratic values. It is all about pluralism and diversity. Entrepreneurs threaten and challenge stifling bureaucracies. They check concentrations of power. They champion the creativity and independence of individuals.

Entrepreneurship is all about choice. Entrepreneurship is the outgrowth of the free expression of ideas. Entrepreneurship is the outgrowth of a capitalist economy that rewards initiative. By definition, entrepreneurship requires for its very existence a social and political system that fosters individuality, freedom, creativity, growth, and change.

Fostering entrepreneurship in turn fosters the growth of American values and our abiding faith in progress. A rising standard of material wealth, a sense of progress, and a believe in opportunities for individuals is indispensable for our political, economic and social stability.

³The Entrepreneurs Agenda was published by the Entrepreneurs Coalition in June of 1996. The Coalition is composed of the Biotechnology Industry Organization, Council of Growing Companies, the Nasdaq Stock Market, National Venture Capital Association, and Software Publishers Association.

⁴Entrepreneurs: Architects of Innovation, Paradigm Pioneers and Change, Eric K. Winslow and George T. Solomon, *Journal of Creative Behavior*, Second Quarter 1993 at 80–81.

⁵"Where is the Passion...and Other Elements of Innovation," F. Hertzberg, in *Key Issues in Creativity, Innovation, and Entrepreneurship*, Bruce G. Whiting and George T. Solomon, 1989.

Freedom and choice makes the entrepreneurial behavior possible. Entrepreneurship in turn makes freedom and choice possible. The synergy is fundamental to our nation's successes and leadership.

Studies of entrepreneurs find that the primary, driving motivation of the entrepreneur is independence. The motivation is not money as is popularly assumed.⁶ There can be no more American value than the value of independence—first for our country and always for the individual.

The economic definition of an entrepreneur can be abstract and sterile. One definition of “entrepreneurship” focuses on “the process activity of creating value by bringing together a unique combination of resources for the purpose of exploiting an opportunity.”⁷ A simpler definition is that provided by Peter Drucker, legendary business observer: “An entrepreneur is someone who gets something new done.”⁸ These formal definitions do, however, focus on quintessential American values—resourcefulness, action, and practicality.

Candidates and policy makers should support the Entrepreneurs Agenda because it reflects fundamental American economic and social values and benefits the individual, the economy, and the community.

ENTREPRENEURS CREATE JOBS

Entrepreneurs are synonymous with jobs. This is the common view in America, but it is also the view of economists who have documented it in numerous studies.

Comparison to Fortune 500: The bottom-line is dramatically stated: between 1980 and 1990 U.S. private sector employment grew by 19 million jobs, but employment in the Fortune 500 firms dropped by 3 million jobs.⁹ This means that employment in the non-Fortune 500 firms had to grow by 22 million jobs to make up for the loss with the larger firms.

We are seeing an accelerating decline in the ability of Fortune 500 firms to maintain their competitiveness. The replacement rate for Fortune 500 firms was approximately 8% in the 1960s, jumped to 30% in the 1980's, and approached 40% in the 1990s. Almost half of the largest industrial firms are now replaced by new firms every five years. For high technology firms approximately 25% of the firms are replaced every five years.¹⁰

Rate of Growth: In 1994 small-business-dominated industries added jobs to the economy at 1.3 times the national rate of increase of 3.5% while large-business-dominated industries added jobs to the economy at one-third the national rate (only a 1% increase).¹¹

Number of firms: The Office of Science and Technology Policy (OSTP) estimated in 1992 that there are 75,000 to 100,000 small high-technology firms in the United States with 1.75 to 2 million direct employment.¹² This figure does not include the suppliers, retailers, or service personnel whose employment is dependent on these businesses. OSTP puts these statistics in perspective as follows:

While the small high technology business sector represents only a few percent of the total small business sector work force, the economic, technological, and social impact of these technically based firms is profound (due to the impact of their products on our daily lives).¹³

OSTP found that the “small high-tech firms are dynamic in the creation of new jobs.” In the decade from 1976 to 1986, it found that “employment growth in the high-tech sector was the highest of any sector of the economy.”¹⁴ Small high-tech firms contributed over one-third of the increase in new jobs for the entire high-tech sector and firms with fewer than 20 employees “accounted for fully half of this

⁶Albert Shapeero, Taking Control, commencement address at Ohio State University, 1982 (cited in Public Policy Affecting Entrepreneurship, Venture Capital, and Technology, Gerald L. Feigen, Small Business Administration).

⁷“Sustaining the Entrepreneurial Society,” Michael H. Morris, prepared for the Small Business Foundation of America.

⁸“Flashes of Genius,” *Inc.* (Special Issue: State of Small Business, May, 1996) at 43 (italics in original).

⁹“Risk and Innovation: The Role and Importance of Small High-Tech Companies in the U.S. Economy,” National Academy of Engineering, 1995, at v.

¹⁰A Profile of Small High Technology Business in the United States, Office of Science and Technology Policy, Executive Office of the President, Joseph S. Broz, David C. Cranmer, and Mark DeSantis, 1992, at 18.

¹¹Small Business Administration data.

¹²A Profile, OSTP, at 1.

¹³Profile, OSTP, at 1.

¹⁴A Profile, OSTP, at 2.

growth.” In aggregate numbers, the high technology firms contributed “nearly four times their expected share of new jobs.”¹⁵

Comparison to Basic Industries: The comparison between small and medium-sized high technology firms and the “once dominate basic U.S. industries, such as steel, autos, and consumer electronics” is particularly startling. From January 1989 to September 1991, “durable goods manufacturers lost 8.3% in total employment. In contrast, during the same period, small and mid-sized technology manufacturers increased employment by 10.6%.”¹⁶

Hot Growth Companies: The *Business Week* annual survey of 100 “hot growth” companies provides graphic evidence of the growth potential of entrepreneurial firms.¹⁷ This year’s survey found average sales increases of 60%, average profit increases of 140%, and average rate of return increases of 27%. The total market capitalization of the 100 firms companies is \$40 billion. Of the 100 firms, 33 were ranking on the same list the year before. The top ranking growth companies included Remedy (ranked no. 1), a software company with a 160.5% increase in sales, a 272.9% increase in profits, and a 43.4% increase in return on capital. Software and computer-service providers made up 23 of the listed companies, while semi-conductors, components, and telecommunications added 10 more. As the article states in bold type, “Unslackable demand for technology fueling many of this year’s highfliers.”¹⁸

The *Inc.* annual survey of the 100 fastest growing small public companies documented the same point.¹⁹ The median five year sales growth for the companies was an astounding 2,239% and the median sales had grown from \$1,796,000 to \$47,144,000 in five years. The median number of employees had risen from 31 to 260 in five years and the median productivity of the employees had risen from \$52,289 to \$167,310 in five years. The top ranked firm, AmeriData Technologies, sells computers and integrates computer systems and its sales had grown 135,647% in the past five years.²⁰

Critical Technologies: Many of the new technologies and industries seen as critical to the Nation’s future economic growth are closely identified with small business.²¹ And, the establishment of these firms is relatively recent. Even though the late 1980s saw a sharp decline in the company formation from the earlier part of the decade, almost half of all U.S. high-tech companies operating in 1993 were formed since 1980.²²

For example, the Board reports that 60% of the computer-related, biotechnology firms and software firms were founded since 1980. The 1980–1993 period saw the founding of 490 automation companies, 358 biotechnology companies, 1,253 computer hardware companies, 243 advanced material companies, 296 photonics and optics companies, 3,395 software companies, 807 electronic component companies, 593 telecommunications companies, and 7,246 in chemicals, defense-related, energy, environmental, manufacturing equipment, medical, pharmaceutical, subassembly and components, test and measurement, and transportation companies. Fully 48 percent of the total of 22,728 companies in these fields were founded between 1980 and 1993.

These statistics may drastically understate the growth in these sectors. For example, while the Science Board reports the creation of 358 biotechnology companies during this period, the keeper of the most reliable statistics on this subject—Ernst

¹⁵ A Profile, OSTP, at 2 (citing Paul Hadlock, Daniel Hecker, and Joseph Gannon, High Technology Employment: Another View, Monthly Labor Review July 1991 and Bruce D. Phillips, The Increasing Role of Small Firms in the High-Technology sector: Evidence from the '80's, Business Economics January 1991)

¹⁶ A Profile, OSTP, at 2 (citing CorpTech, Inc., 1991, and U.S. Department of Labor, Bureau of Labor Statistics, Statistical Abstract, 1991).

¹⁷ To qualify for the list a company must excel in a three year average growth of sales, profits, and return on invested capital. Companies must have had annual sales of more than \$10 million and less than \$150 million, a current market value of more than \$1 million, a current stock price of greater than \$2, and be actively traded in a public capital market.

¹⁸ Hot Growth Companies: Corporate America is Slowing? Don't Tell These Dynamos, *Business Week*, May 27, 1996, at 110–126.

¹⁹ To qualify for the list companies had to be independent, publicly held companies, had to have gone public no later than December 31, 1995, there had to be an active market for their stock, and they had to have had sales of no less than \$200,000. The only criteria for ranking was sales growth.

²⁰ Show Time: Thirty-one of this year’s *Inc.* 100—the fastest-growing small public companies in American—became public just last year. Next year, expect more, *Inc.*, May 1996, at 34–42.

²¹ Science and Engineering Indicators—1993 (U.S. National Science Board, 1994) at 185.

²² Science and Engineering Indicators—1993 (U.S. National Science Board, 1994), at 185.

and Young—reports that 974 biotechnology companies were founded between 1980 and 1993²³—a difference of 272%.

Venture Capital-Backed Firms: Venture capital-backed firms are prolific creators of jobs. Venture-backed firms increased employment by an average of 20% per year from 1990 to 1994 at a time when Fortune 500 firms lost nearly 1% of their employees per year. By the time a venture-backed firm is six years old, it typically employs 282 people. The percentage of these jobs taken by engineers, scientists, and managers is 61%, four times the percentage of the workforce as a whole.²⁴

Nasdaq-Listed Companies: Companies traded on the Nasdaq Stock Market make up four tenths of one percent of all public and private companies in the United States and have an employment base of approximately three million people (2.5% of the U.S. total), but in the period from January 1990 through June 1994 they created over one-half million new jobs or more than 16 percent of all new jobs. During the same time period Fortune 500 firms lost about 200,000 jobs per year. Compared to a national growth rate of about 3 percent, 51 percent of the Nasdaq companies are growing at 20 percent or higher. This is equivalent to a 100 person firm growing to at least 145 employees in a four and a half year period. Fully 80 percent of this explosive job growth comes in Nasdaq firms with 1,000 or more employees. The key seems to be firms with an average revenue base of \$100 million—a take-off point for growth.²⁵

Women-Owned Businesses: Growth in the number of women-owned businesses has been particularly spectacular. The number of women-owned sold proprietorships, partnerships, and subchapter's corporations has risen from 2.6 million in 1982 to 5.889 million in 1992. For this entire decade the increase is 125 percent or 8.5 percent compounded annually—more than twice the rate of all businesses. When the 511,000 women-owned subchapter C corporations are added, the total rises to 6.4 million firms. In 1992 women owned 32.1 percent of all firms in the United States. Women-owned firms with employees constituted 11 percent of the total of new businesses between 1987 and 1992, a 32 percent growth rate. These firms with employees provided 94 percent of the total revenue for the women-owned business sector—receipts which totaled \$1.5 trillion in 1992—and now make up one-fifth of all the 6.4 million women-owned firms.²⁶

Software Industry Trends/Competitiveness: Although the software industry boasts some large, well-known companies, a recent survey showed that more than 80 percent of the industry is actually made up of software companies with annual revenues under \$10 million.²⁷ The employment of large numbers of highly skilled workers, heavy investment in research and development, and high growth of production and exports further qualify the U.S. software publishing industry as an excellent example of a developing entrepreneurial industry.

Between 1987 and 1993, the annual average growth rate for the industry increased by 20 percent. During this five year period, international sales grew by an average annual rate of 13 percent per company, representing \$26,665, and 48 percent for the entire period. The growth in international sales would be much larger, at least double by conservative estimates, if it were not for widespread international piracy of software. Protection of intellectual property rights is a high priority for the Entrepreneurs Coalition.

The U.S. has nearly 500,000 people directly employed in software development, and the numbers are growing rapidly. According to statistics developed by the U.S. Department of Commerce and the WEFA Group, between 1987 and 1993 software industry employment increased by 10.5 percent annually.²⁸

Employee compensation, a highly important criterion for measuring the industry's contribution towards the economy, also reflects the software industry's prosperity and growth. Labor compensation grew at an annual average rate of 8.4 percent, or \$18,256, between 1987 and 1992, and the average compensation measured by total payroll grew at an annual rate of 20.1 percent during the same five year period.²⁹

²³ Biotech 96: Pursuing Sustainability: The Tenth Industry Annual Report, Kenneth Lee and Steven Burrill, September 1995 at 43. This report covers both public and non-public companies.

²⁴ Economic Impact of Venture Capital Study, Coopers and Lybrand (Sixth Annual study), 1996.

²⁵ The Role of Nasdaq Companies in the U.S. Economy, Cognetics, Inc., June 1, 1995.

²⁶ U.S. Census and Small Business Administration data.

²⁷ 1996/1997 Software Business Practices Survey, Price Waterhouse LLP, Massachusetts Software Council, Software Publishers Association, and Information Technology Association of America (6th Annual)(1996), at 38.

²⁸ Economic Contribution of the Packaged Software Industry to the U.S. Economy, August, 1994; WEFA Group, at 15.

²⁹ Ibid.

Stability and Growth: Inc. found in 1996 that entrepreneurial firms are remarkably durable. It surveyed the entire *Inc.* 500 group from the class of 1985 and found that only 19% were no longer in business or could not be located. Another 275 had been sold to a new owner, six percent had gone public, and 48% were still privately held under the same ownership. The companies had generated \$7.4 billion in revenue in 1984 and \$64 billion in 1994 and 29,000 employees in 1984 and 127,000 in 1995. The 32 companies which went public grew by \$18.9 billion in revenues from 1984 to 1994, and they created 59,900 new full-time jobs. That's an average of 30% revenue growth per year and an average of 1,872 new jobs created by each company each year. Microsoft is one of these companies, along with Oracle, Solectron, Tech Data Corp., and Merisel—all high technology companies. In this process 10,000 jobs were lost at the 95 companies which no longer exist or could not be found, but this was dwarfed by the job gains at the 233 companies which survived and remained independent of 92,000—a net job growth of 81,900.³⁰

Workplace Quality of Life: In the age of “economic anxiety” there are powerful reasons to work for entrepreneurial firms. In a major survey of attitudes towards their workplace quality of life, *Inc.* found that employees of small entrepreneurial firms were more likely to say that they had an opportunity “at work to learn and grow,” that the mission of their employer makes them “feel your job is important,” that they used a higher percentage of their ability, that they wanted to be a leader in their firm someday, that the management did “what is necessary to make your company a great place to work,” and that their company was a “good workplace for all of the people (and not) for only the privileged few.”³¹

Stability was a hallmark of these companies. In another survey by *Inc.* 68% of these firms still have their headquarters in the same town and a majority of those that had relocated moved less than 20 miles away. Only 4% had moved their headquarters across state lines.³²

High Tech Sector Job Growth: Small high technology firms with 500 or fewer employees created over 400,000 jobs in 1990, four times their expected share of new jobs. In one recent one-year period 40% of the jobs created were in the computer-related industries and seventy-six percent of the total number of high technology jobs created were in firms of between 50 and 500 employees.³³ The study found that small, high-technology firms create more new jobs than any sector of the economy—and they keep producing jobs.

Entrepreneurial firms continue creating new jobs because of growth of the existing firms and growth of the number of firms. The OSTP study found small, high-technology firms are 300 percent more likely to create a new job than any other type of firm. The rate of job growth changes by the size of the firm:

³⁰ Martha E. Mangelsdorf, *The Startling Truth About Growth Companies, Inc.* (Special Issue: State of Small Business, May 1996), at 85.

³¹ Jeffrey L. Seglin, *The Happiest Workers in the World, Inc.* (Special Issue: State of Small Business, May 1996), at 62.

³² Martha E. Mangelsdorf, *The Startling Truth About Growth Companies, Inc.* (Special Issue: State of Small Business, May 1996), at 85.

³³ *A Profile*, OSTP, at.

Number of High Technology Firms by Employment Size in 1976–1986

Employment Size	Number of Business		Annual Growth Rate (%)
	1976	1986	
1–99	50,245	8350,245	5.22%
100–499	2,554	3,789	4.02%
500–999	292	459	4.63%
1,000–9,999	432	520	1.87%
10,000 & up	133	135	0.15%
Totals	53,656	88,453	* 5.13%

*A *Profile*, OSTP, at 17 (emphasis added)(citing William K. Scheirer, “The Population and Birth Rates of High Technology Firms, 1976–1986,” study commissioned by U.S. Small Business Administration).

The more entrepreneurial the firm, the more growth in jobs. The highest job growth is focused in a small group of high-growth entrepreneurial firms—10 percent of small companies created 75 percent of new jobs created since 1970.

Job growth rates of 10–12 percent as a yearly average for high technology companies are common according to a CorpTech study based of the NSF *Science and Engineering Indicators*. This study shows net growth of jobs by industry:

	Employment Growth Rate Last Year	No. of Jobs Created Last Year
Automation	12.6	58,471
Biotechnology	10.6	16,468
Computer hardware	14.5	148,304
Computer software	13.9	103,479
Advanced materials	5.8	32,452
Photonics & optics	8.4	27,654
Telecommunications	* 12.7	61,280

*A *Profile*, OSTP study, at 20.

Impact of Job Growth: Over 400,000 jobs were created in the high technology sector by small technology firms in 1990 alone.³⁴ Small high tech firms created four times their expected share of new jobs and in a one-year period, 40% of the jobs created were in computer-related industries.³⁵ The OSTP study found that small high-tech firms contributed 38% of the 2.2 million new jobs in the entire high technology sector between 1976–1986. These figures are twice as high as the growth rate for the economy as a whole.³⁶

In the period of 1977–1987 employment in computer and data processing firms grew by an astonishing 252%, creating 450,000 new jobs. Employment in firms producing scientific and measuring instruments grew 210%, medical and ophthalmic goods grew 62%, office and computing equipment grew by 35%, and electronic components and accessories grew 25%. This compares to a drop in employment for firms producing general industrial machinery of 9%, a drop of 44% for engines and turbines, a drop of 40% for Radio, TV, and communications equipment, and a drop of 47% for firms in construction and related machinery.³⁷

Economic Stars: These entrepreneurial new businesses grow and can become the nation’s largest and most successful corporations. Microsoft, Hewlett Packard and Genentech are all billion-dollar businesses that began as entrepreneurial startups. Today these firms employ more than 100,000 employees.

Almost half of the largest industrial firms in the United States are now replaced by “upstarts” every five years. Of the 1,400 largest high-technology firms in the United States, 41 percent have been created since 1980, 31 percent since 1983 and 14 percent since 1987—clearly age and size are not a protection. The new startup of today may be the billion-dollar corporation of tomorrow.

³⁴A *Profile*, OSTP study, at 30 (citing Science and Engineering Indicators—1991).

³⁵A *Profile*, OSTP study, at 30.

³⁶A *Profile*, OSTP study, at 30.

³⁷*State of Small Business Report*, 1992, Small Business Administration, at 83.

Self-Made Wealth: Ten years ago, 40% of the Forbes Four Hundred Richest People in America were entrepreneurs, self-made individuals who created their own wealth rather than inheriting it. By 1994, 80% of the wealthiest were self-made.³⁸

High-Wage Jobs: The industries comprising the Coalition are prime examples of this subject. The average salary in the U.S. biotechnology industry is \$50,000. Biotech companies directly employ over 108,000 jobs in the U.S. Over two thirds of biotechnology companies employ less than 50 workers.³⁹ The percentage of highly skilled engineers, scientists, and managers generated by young venture capital-backed companies is over 4 times the percentage of skilled jobs created in the economy as a whole (61% vs. 14%).⁴⁰ At small businesses with less than 500 employees, 54.8% earn more than \$21 per hour as a starting salary, vs. only 45.2% at firms with more than 500 employees. This indicates that recently hired workers in small firms are obtaining a major share of high-wage jobs. Large firms continue to shed high-wage jobs, particularly management jobs.⁴¹

In addition to high wages, entrepreneurial firms use incentive stock options to compensate and motivate employees. These stock options tend to be granted to all employees, not just the elite management. For example, in the biotechnology industry 80% of the firms had stock option plans and 82% of these were company wide.⁴²

Quality of Life Impact: These entrepreneurial firms create new products that in themselves create or stimulate new industries. Entrepreneurial companies have a multiplier impact on the creation of jobs and new economic growth. For example the creation and growth personal computer and biotechnology—whole new industries—resulted from the catalyst of entrepreneurial firms. Changes in job growth also signal changes in the structure of the larger economy. The growing significance of entrepreneurial firms to job growth signals a change of the economy and appreciation for the underlying strength and dynamism of the economy. We are in a massive restructuring of the American economy—the transition from a declining industrial/manufacturing economy to an emerging entrepreneurial/innovation-driven economy.

ENTREPRENEURS ARE LEADERS IN RESEARCH AND INNOVATION

Research and innovation is one of the keys to economic growth and American high-technology firms are the world's leaders in innovation.

Technological Change: The State of Small Business Report finds that technological change is responsible for a significant portion of increases in the standard of living.⁴³ The Office of Science and Technology Policy reports, A large and growing body of research indicates that new, small firms are the major force for technological change in our economy by innovating more efficiently than their larger counterparts.⁴⁴

The Council of Economic Advisors finds that advances in knowledge contribute importantly to the Nation's real economic growth; about one-half of all growth in output per capital has been attributed to the technological knowledge and managerial and organizational know-how⁴⁵ and that technology changes alone are responsible for about 30 percent of the increases in gross domestic product between 1947 and 1992.⁴⁶ It has found that technological change has played a central role in economic growth⁴⁷ and that these innovations have led to a transformation of society over the past two centuries.⁴⁸

Research Intensity: Small firms tend to be more research intensive. This research intensity is critical to our standard of living. The estimated rate of return on private

³⁸ William E. Wetzel, "Economic Policy in an Entrepreneurial World," *Venture Capital Journal*, August 1995, at 53.

³⁹ *Biotechnology Compensation and Benefits Survey*, Radford Associates/Alexander and Alexander Consulting Group (1995) and *Biotech '96: Pursuing Sustainability*, Ernst and Young (10th Annual Survey).

⁴⁰ *Sixth Annual Economic of Venture Capital Study*, NVCA/Coopers and Lybrand LLP., 1996.

⁴¹ *The Third Millennium: Small Business and Entrepreneurship in the 21st Century*, Small Business Administration, Office of Advocacy, from data compiled by Joel Popkin and Company (Special publication prepared for delegates to the 1995 White House Conference on Small Business).

⁴² *Biotechnology Compensation and Benefits Survey*, Radford Associates/Alexander and Alexander Consulting Group, 1995.

⁴³ *State of Small Business Report*, 1994, Small Business Administration, at 109.

⁴⁴ *A Profile*, OSTP, at 2.

⁴⁵ *Economic Report of the President*, 1989, U.S. Council of Economic Advisors, at 223.

⁴⁶ *Economic Report of the President*, 1994, U.S. Council of Economic Advisors, at 44.

⁴⁷ *Economic Report of the President*, 1990, U.S. Council of Economic Advisors, at 111.

⁴⁸ *Economic Report of the President*, 1992, U.S. Council of Economic Advisors, at 111.

R and D spending range from 20% to 50%, but the rate of return to society has been estimated to be about double the private rate of return.⁴⁹

The percentage of domestic employees who were R and D scientists and engineers was 6.41 percent in small R and D firms and 4.05 percent in large firms and R and D funds as a percentage of domestic net sales were 4.25 percent in small firms and 3.89 percent in large firms.⁵⁰

One study of intellectual property finds small technology firms to be more research-intensive than larger firms. The median R and D expenses as a percent of sales was 5% of less for large firms with intellectual property and 11% for small firms.⁵¹ 14% of the small firms having R and D expenses which were more than 40% of sales and there were no large firms with R and D expenditures of this magnitude.⁵²

The staggering research intensity of high technology firms is confirmed each year in the *Business Week* survey on R and D expenditures.⁵³ The survey measures the percentage of increase in absolute terms and also the research intensity as a percentage of sales or on a per employee basis. The 1995 survey finds a 14% increase in R and D by electrical and electronics firms, which spent \$9.6 billion on research, 5.7% as a percentage of sales, and \$8,257 per employee. Office equipment and sales firms spent \$15,898 per employee on research, health care firms spent \$18,451 per employee, and chemicals spent \$10,289 per employee. The all industry averages are 4% increases, 3.5% as a percentage of sales, and \$7,651 per employee.

In terms of spending per employee the top ten firms were all high technology firms: Biogen (biotechnology), \$210,654 per employee; Genetics Institute (biotechnology), \$114,943; Genentech (biotechnology), \$112,030; Immunex (biotechnology), \$102,719; Amgen (biotechnology), \$91,266; S3 (multimedia chips), \$82,548; Cyrix (computer hardware) \$80,113; Adobe Systems (software), \$70,993; Platinum Technology (hardware and software), \$69,787; and Altera (hardware and software), \$68,956.

In relation to sales the top research firms were Genetics Institute, 82.6%; Biogen, 65%; Platinum Technology, 54.2%; Immunex, 53.7%; Chiron (biotechnology), 44.7%; Genentech, 40.8%; Continuum (software), 34.3%; Viewlogic Systems (hardware), 30.8%; Alza (biotechnology), 29.2%; and MacNeal-Schwendler (software), 29.2%.

In terms of total spending on research the top firms were General Motors, \$7 billion; Ford Motor, \$5.2 billion; IBM, \$3.4 billion; AT&T, \$3.1 billion; Hewlett-Packard, \$2 billion; Motorola, \$1.9 billion; Boeing, \$1.7 billion; Digital Equipment, \$1.3 billion; Chrysler, \$1.3 billion; and Johnson and Johnson, \$1.3 billion.

Another study regarding firms with new products found that small firms obtained more patents per sales dollar than larger firms even though small firms were less likely to obtain patents than larger firms, indicating that the finding understates the point.⁵⁴

Biotechnology Industry Research: The biotechnology industry is one of the most research intensive industries in the civilian manufacturing sector. The average biotechnology company spends \$71,000 per employee on research, more than nine times the U.S. corporate average of \$7,650.⁵⁵ Ernst & Young⁵⁶ reports that biotechnology companies spent \$7.7 billion on research and development in 1995, up eight percent over 1994.

Software Industry Research: The success of the software industry, and its growth of high paying, high-skill jobs is attributable to its heavy investment in research and development of new products. Approximately 85 percent of the products sold by U.S. software companies are developed in-house. At the typical U.S. software company, the largest department, in terms of number of employees, is the research and development department. U.S. software companies spend approximately 15 percent of their revenue on R&D, with half of R&D expenditures going to salaries and benefits for employees. Only by maintaining high levels of R & D spending can U.S. software companies retain their global technological leadership.

⁴⁹ *Economic Report of the President*, 1989, U.S. Council of Economic Advisors, at 223.

⁵⁰ *State of Small Business Report*, 1994, Small Business Administration at 115-117 (citing U.S. Census data).

⁵¹ *State of Small Business Report*, 1994, Small Business Administration, at 117.

⁵² *State of Small Business Report*, 1994, Small Business Administration, at 117.

⁵³ "Blue-Sky Research Comes Down to Earth," *Business Week*, July 3, 1995, at 78-80.

⁵⁴ *State of Small Business Report*, 1994, Small Business Administration, at 119 (citing a study by John Hansen, Utilization of New Data for the Assessment of the Level of Innovation in Small American Manufacturing Firms, study commissioned by the SBA, 1989).

⁵⁵ Back to Basics, *Business Week*, July 3, 1995, at 78.

⁵⁶ A fiscal year for Ernst & Young is from July 1 through June 30. Therefore, 1995 indicates July 1, 1994 through June 30, 1995.

The industry as a whole designates 20 percent of employee resources for research and development of new products. A recent study found that small and mid size companies allocate more resources to R&D than do their larger counterparts in the industry. Specifically, companies with revenue less than \$1 million and between \$1-\$10 million designate 30 and 23 percent of their respective labor resources.⁵⁷

Research at Venture Capital-Backed Firms: Venture capital-backed companies tend to be research-intensive. By the time a typical venture-backed company is five years old, it has already invested \$13.5 million to create breakthrough products and services. From 1990 to 1994 these firms increased their R and D investment by 36%, compared to only 11% for Fortune 500 firms. The average R and D per employee is \$20,000, compared to only \$9,000 for a Fortune 500 firm. Over the past five years, venture-backed companies increased their investment in R and D at twice the rate of Fortune 500 companies, 30% compared to 14.7%.⁵⁸

Firm-University Ties: The relationship between entrepreneurs and research-intensive universities is found in another study. New small technology-based firms were found to be much more likely to be formed close to these universities, non-profit research institutions and other high technology firms.⁵⁹

Research intensity is directly related to innovations which can change our economy and change our lives. It is no surprise to find that research-intensive firms are prolific innovators.

Small Firms as Innovators: The Small Business Administration has completed a comprehensive study of 8,074 innovations in 363 industries from 46 technology, engineering, and trade journals and found that small firms were responsible for 55 percent of the innovations.⁶⁰ The study found that small firms produce twice as many product innovations per employee as large firms and twice as many significant innovations per employee.⁶¹ A previous study has estimated that the ratio is 2.45 innovations per employee of small to large firms.⁶²

List of Innovations: The Small Business Administration has prepared an impressive list of important innovations brought to market by small firms.⁶³ The list includes air conditioning, air passenger service, the airplane, artificial skin, assembly line, audio tape recorder, biomagnetic imaging, catalytic petroleum cracking, continuous casting, cotton picker, defibrillator, DNA fingerprinting, double-knit fabric, electronic spreadsheet, FM radio, geodesic dome, gyrocompass, heart valve, helicopter, human growth hormone, hydraulic brake, integrated circuit, microprocessor, optical scanner, oral contraceptives, outboard engine, overnight national delivery, pacemaker, personal computer, photo typesetting, polaroid camera, portable computer, prestressed concrete, pressure sensitive cellophane tape, programmable computer, quick-frozen foods, safety razor, six-axis robot arm, soft contact lens, solid fuel rocket engine, strobe lights, supercomputer, vacuum tube, xerography, X-ray telescope, and the zipper. There are undoubtedly tens of thousands of other examples.

The reasons for high innovation levels in small, high-tech firms are varied. Some studies focus on the greater economic incentive to innovate in small firms and the bureaucracy of big firms. Other studies suggest large firms may over-specialize and cite reduced contact between customers and developers. Whatever the reasons, the data clearly show the effectiveness of innovation of small, entrepreneurial, high-technology firms.

ENTREPRENEURS ARE COMPETITIVE

High technology firms provide the competitive advantage American needs in new, high-growth industries. Success in this competition is critical to America's economic prospects and standard of living.

Level of Competition: Americans have the perception that the level of competition has increased the pressure on U.S. firms. This perception is accurate and arises

⁵⁷ 1996/97 *Software Business Practices Survey*, Price Waterhouse LLP, Massachusetts Software Council, Inc., Software Publishers Association, Information Technology Association of America (sixth annual) 1996, at 38.

⁵⁸ *Economic Impact of Venture Capital Study*, Coopers and Lybrand (Sixth Annual), 1996.

⁵⁹ *State of Small Business Report*, 1994, Small Business Administration, at 120 (citing a study by Stephen Geoffrey Graham, *The Determinants of the Geographical Distribution of the Formation of New and Small Technology-based Firms*, 1981 Michigan State University Ph.D. Dissertation).

⁶⁰ *State of Small Business Report*, 1994, U.S. Small Business Administration, at 113.

⁶¹ *State of Small Business Report*, 1994, at 114.

⁶² Earl E. Bomberger, *The Relationship Between Industrial Concentration, Firm Size, and Technology Innovation* (SBA commissioned report cited in 1994 *State of Small Business Report* at 114, note 20.)

⁶³ *State of Small Business Report*, 1994, at 113.

from the fact that the share of our gross national product that is involved in internationally traded goods has doubled from 1950 to 1990 and now stands at 22.3 percent.⁶⁴ This percent is projected to rise to one-third during the next decade. There is increased pressure.

Competition is increasing from both developed and developing countries and our vulnerability to pressure from imports and our dependence on exports is growing. There is pressure for higher quality and lower prices, better service, and more innovation. The life-cycle of products, and the ability of the innovator to maintain dominance in a given market, has decreased.

Entrepreneurial firms are able to handle this pressure to compete.

Venture Capital-Backed Firms: Venture capital-backed firms aggressively grow export sales to improve our balance of payments. Their average export sales growth was 57% (1993–1994), up from 11% (1991–1992). This shows that these firms are exploiting newly opened markets. The average venture-backed firms grew its sales to employee 9 percent each year, more than three times the productivity growth rate for the Fortune 500 companies.⁶⁵

Our high technology firms are ready, willing, and able to compete in international markets and they are our greatest single economic strength in an increasingly competitive world economy.

Biotechnology Industry Competitiveness: A case study of American competitiveness is the biotechnology industry. The United States currently has the dominant biotechnology industry when compared with any other country in the world. Precisely because the U.S. is preeminent in the field of biotechnology, it has become a target of other country's industrial policies. In 1991, the Office of Technology Assessment (OTA) found that Australia, Brazil, Denmark, France, South Korea and Taiwan (Republic of China) all had targeted biotechnology as an enabling technology. Furthermore, in 1984, the OTA identified Japan as the major potential competitor to the United States in biotechnology commercialization.⁶⁶

The OTA also identified the manner in which Japan had targeted biotechnology. The report stated,

In 1981, the Ministry of International Trade and Industry (MITI) designated biotechnology to be a strategic area of science research, marking the first official pronouncement encouraging the industrial development of biotechnology in Japan. Over the next few years, several ministries undertook programs to fund and support biotechnology.

One of the Japanese ministries, the Ministry of Health and Welfare (MHW), instituted a policy whereby existing drugs would have their prices lowered, while allowing premium prices for innovative or important new drugs, thus forcing companies to be innovative and to seek larger markets.⁶⁷

It is widely recognized that the biotechnology industry can make a substantial contribution to U.S. economic growth and improved quality of life. For example:

- The National Critical Technologies Panel, established in 1989 within the White House Office of Science and Technology Policy by an Act of Congress,⁶⁸ calls biotechnology a "national critical technology" that is "essential for the United States to develop to further the long-term national security and economic prosperity of the United States."⁶⁹

- The private sector Council on Competitiveness also calls biotechnology one of several critical technologies that will drive U.S. productivity, economic growth, and competitiveness over the next ten years and perhaps over the next century.⁷⁰

- The United States Congress' Office of Technology Assessment calls biotechnology "a strategic industry with great potential for heightening U.S. international economic competitiveness." OTA also observed that the "wide-reaching potential applications of biotechnology lie close to the center of many of the world's major problems—malnutrition, disease, energy availability and cost, and pollution.

⁶⁴ Data Resources Inc. projections.

⁶⁵ *Economic Impact of Venture Capital Study*, Coopers and Lybrand (Sixth Annual), 1996.

⁶⁶ U.S. Congress, Office of Technology Assessment, *Biotechnology in a Global Economy* 243 (October 1991).

⁶⁷ U.S. Congress, Office of Technology Assessment, *Biotechnology in a Global Economy* 244–245 (October 1991).

⁶⁸ National Competitiveness Technology Transfer Act, Pub. L. No. 101–189, 103 Stat. 1352 (42 U.S.C. § 6681 et seq.).

⁶⁹ White House Office of Science and Technology Policy, *Report of the National Critical Technologies Panel 7* (1991).

⁷⁰ Council on Competitiveness, *Gaining New Ground: Technology Priorities for America's Future* 6 (1991).

Biotechnology can change both the way we live and the industrial community of the 21st century.⁷¹

• The National Academy of Engineering characterizes genetic engineering as one of the ten outstanding engineering achievements in the past quarter century.⁷²

Global Competitiveness of the Software Industry: The software industry is another example of a competitive U.S. industry. The software industry is a modern and evolving electronic industry with revenues of more than \$200 billion and a growth rate of 13% a year. Software is now one of the world's largest and fastest-growing industries. Before the mid-1980's, most computers were mainframes and minis that were sold with proprietary software created by the manufacturer for the computer. The hardware and operating systems software were bundled together (the software was placed in the hardware), and the customer usually paid for the software through the price that was paid for the computer.

The development of personal computers spawned independent software companies that sold software separately to PC buyers. At the time, mainframe and mini hardware manufacturers began to unbundle their products presenting independent software companies with the opportunity to compete by offering "open systems" of software for mainframes and minis that offered customers more flexibility, performance and features.

Since then, the growth and competitiveness of the U.S. software industry has exploded. The software industry (prepackaged software, custom computer programming services, and computer integrated design) contributed \$36.7 billion of value to the U.S. economy in 1992. Employment in the software industry increased at double digit rates through much of the 1980's. It is estimated that nearly 500,000 people are currently employed in the software industry.

Beyond the core industry, it is estimated that nearly 2 million U.S. jobs are tied to software programming, a number which clearly eclipses all of our major international competitors.

The U.S. software industry is also an export engine. The U.S. makes an estimated 75% the pre-packaged software sold worldwide, an amount exceeding \$100 billion.

Foreign Sales Exports of U.S. Industries

Industry	1994 (billions)
Chemicals and allied products	\$51.6
Agricultural sector	42.6
Automotive parts and accessories	37.1
Aerospace	35.8
Computers and peripherals	30.4
Petrochemicals	26.6
Prepackaged Software Sales	26.3
Food and kindred products	25.6
Electronic components and accessories	24.5
Motor vehicles and car bodies	22.0
Semiconductors and related devices	18.0
Organic chemicals	12.3
Telecommunications equipment	12.3
Paper and allied products	11.1
Drugs	7.6
Textile mill products	5.2

These same themes can also be stated for wages. In 1992, the average compensation per employee in the software industry was over \$55,000. Compensation grew at an annual rate of 8.4 percent from 1987 to 1992. Auto industry compensation grew at the annual rate of only 4.6 percent, while the motion picture industry wages grew at the rate of only .7 percent. Total software industry payroll grew at an annual rate of over 20 percent from 1987 to 1992, going from little over \$2 billion to over \$5 billion. By contrast, the recorded music industry grew at the rate of only 4 percent, going from \$266 million to \$328 million. The motion picture industry payroll grew at the relatively lackluster rate of 7.7 percent.

⁷¹U.S. Congress, Office of Technology Assessment, *New Developments in Biotechnology: U.S. Investment in Biotechnology-Special Report* at 27 (July 1988).

⁷²National Academy of Engineering, *Engineering and the Advancement of Human Welfare: 10 Outstanding Achievements 1964-1989* 2 (1989).

Small Firm Competitiveness: The OSTP study summaries the way in which small firms enhance U.S. competitiveness in international markets.

The importance of small high-tech firms to the U.S. economy cannot be overstated; competition in the global economy will inevitably mean that many of the most successful technology firms will eventually succumb to competitive pressure, and as a consequence, a viable pool of smaller firms must be available to replace these firms with newer, updated technology products.⁷³

Foreign Acquisitions: However, American ownership of these high technology firms is an issue. The OSTP study found that outlays by foreign-owned firms to acquire U.S. high technology firms rose sharply from 1988–1992, with Japan buying 65% of the total including 40 advanced material companies, 19 aerospace companies, 25 chemical companies, 93 computer companies, 33 electronics companies, 30 semiconductor equipment companies, 51 semiconductor companies, 31 telecommunications companies, 17 biotechnology companies, and 60 other high tech companies—a total acquisition of 399 companies in a four year period.⁷⁴ The United Kingdom was second in acquisitions with 65, France acquired 41, Canada acquired 14, Germany acquired 17, Switzerland acquired 14, and Taiwan acquired 11.

Chairman ARCHER. Thank you, Mr. Wiggans.

In order to determine whether to ask this panel to come back after lunch or whether to release them, are there Members who wish to inquire?

I hate to ask you to come back after lunch in order to respond to one Member, but the Chair is constrained. I have to conduct a luncheon. So, what I will do is permit Mr. English to Chair the Committee so that he may inquire and, subsequent to his inquiry, release this panel. And then, the Committee will return for the next panel at 5 minutes after 1 p.m.

Mr. ENGLISH [presiding]. I thank the panel for staying. I will keep this relatively brief, and I will consider this a lesson to myself for inquiring. [Laughter.]

First of all, I am going to briefly have, at this point, read into the record of the Committee a very thoughtful letter that I had received from the American Business Conference that speaks to some of the issues that we are addressing today, particularly the effect of changes in the Tax Code, instability in the Tax Code on capital gains, and the consequences it has for the economy in general, and at this point, I will, without objection. [Laughter.]

[The information follows:]

⁷³ *A Profile*, OSTP study, at 2.

⁷⁴ *A Profile*, OSTP study, at 24 (citing Economic Strategy Institute database).

THIS LETTER WAS SENT TO ALL MEMBERS OF THE HOUSE AND SENATE



American Business Conference

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March 10, 1997

The Honorable Philip S. English
 U.S. House of Representatives
 1721 Longworth House Office Building
 Washington, DC 20515-3821

Dear Congressman English:

The signatories of this letter are members of the Board of Directors of the American Business Conference (ABC), a coalition of chief executives of fast-growing, midsize American companies. It is our understanding that a reduction in the tax rate on capital gains (the nominal difference between the selling price of an asset and its initial cost) may be part of the Congressional agenda this year. We are writing you, as representatives of the entire ABC membership, to express our views on this matter.

How to tax capital gains is one of those evergreen issues in American public policy. By our count, over the last three decades Congress has changed the top statutory tax rate on capital gains *eight* times. Over this same period, the capital gains differential -- the percentage difference between the top personal income tax rate and the top rate on capital gains -- has varied from as little as 0 percent to as much as 45 percent.

These fluctuations point to a deep uncertainty about the appropriate tax rate on returns to investment and the proper relationship of that rate to the tax rate on personal income. Such uncertainty has adverse effects.

Investors, confronted with a tax on capital gains that is predictable only in its unpredictability, have difficulty in evaluating the potential payoff of their investments, particularly those that imply a long-term commitment of risk capital. Similarly, other investors, confronted with a larger-than-expected tax on capital gains, *including gains solely attributable to inflation*, often find themselves "locked into" the ownership of assets they would otherwise sell in favor of newer, more promising opportunities. *The instability of the tax code in regard to capital gains is in no one's interest, especially the 43 percent of adult Americans who own stock.*

A Coalition of Growth Companies

No one expects Congress to establish once and forever a capital gains rate and a fixed differential with the personal income tax rate. The tax code will always be subject to alteration. *We do think, however, that if the case for a significant capital gains differential were better understood, both inside and outside Washington, much of the uncertainty surrounding the issue would disappear.* As a result, we would be less likely to see in the future the fluctuations in the capital gains tax that we have witnessed in the past.

In making the case for a significant capital gains differential, our focus at ABC is on equities, that is, stock. We are entrepreneurial business people who have had to tap the equities markets in the past for funds to expand our companies. We will be obliged to do so again, along with many of the new entrepreneurs who start their own businesses each year. Moreover, as members of ABC, we see as one of our goals the creation of an economic environment so that the next generation of American entrepreneurs will have the same or better opportunities to realize their dreams, and by so doing, add to the nation's wealth and create new jobs.

Capital Gains and Saving

Our tax system is biased against saving relative to consumption. Except in the case of tax-advantaged saving vehicles, such as Individual Retirement Accounts, saving is done with after-tax dollars and the return to saving is taxed yet again. In contrast, consumption is financed with after-tax dollars, but the "return" to consumption is not taxed. Spending a dollar today is in this sense less costly than saving a dollar for tomorrow. This is one reason why the United States has such a low level of personal saving.

Correcting this bias should be an urgent economic priority. In the long-term, a cure rests in fundamental tax reform which would systematically equalize the tax treatment of all forms of saving relative to consumption. There are a number of worthy proposals for fundamental reform. ABC, for its part, has long championed the Unlimited Saving Allowance Tax (USA Tax), a bipartisan proposal written and introduced by Senators Pete Domenici and Sam Nunn in 1995 (S. 722).

Our best assessment is that fundamental tax reform, while inevitable, is still years away. In the near-term, with the ultimate goal of fundamental reform in mind, Congress can take piecemeal steps to correct the tax code's bias against saving.

Reducing the tax on capital gains on the sale of equities is one such step (expanding Individual Retirement Accounts is another). Reducing the capital gains tax would obviously have the effect of mitigating the double tax on saving. Citizens would still buy equities using after tax dollars but their return on their

investment would suffer less of a tax bite. *Indeed, from this perspective, the best approach would be to eliminate the capital gains tax entirely.*

Debt versus Equity

As noted above, the tax code systemically favors consumption over saving. *From a corporate perspective, the tax code also favors the issuance of debt over equity.* When corporations issue debt, they can deduct interest payments to their lenders. In contrast, when corporations issue stock, double taxation occurs. Corporate earnings are taxed at the corporate level and again when those earnings are distributed as dividends to stockholders.

This distortion leads to a misallocation of economic resources. Corporations have an obvious incentive to issue more debt than they would if debt and equity received equal tax treatment. People concerned with excess corporate leverage need look no farther than the tax code to understand the source of that phenomenon.¹

Not all corporations have recourse to the tax advantages of debt financing. Borrowing requires collateral. Some of America's most promising companies lack collateral as traditionally understood. Instead of factories, land, and machinery against which to borrow, these companies have ideas and creativity. You cannot underwrite ideas and creativity with debt.²

These companies must perforce issue stock. When they do, they face a cost of capital bloated by the tax code's bias against equity relative to debt. This bias is thus a dead weight on entrepreneurship.

As is the case with the code's favorable treatment of consumption relative to saving, the tax "wedge" between debt and equity would best be corrected through fundamental tax reform that integrates the business and personal income taxes. Integration of the sort contemplated in the USA Tax Act would equalize the treatment of debt and equity.

In the near-term, reducing the tax rate on capital gains would at least mitigate the bias against issuing equity. *Lowering the tax on capital gains would correspondingly lower the rate of return demanded by investors as compensation for investing their money. Thus a corporation's cost of equity capital would be less than it otherwise would be under the present tax regime.*

¹ "[T]he tax bias against corporate equity can encourage corporations to increase debt financing beyond levels supported by nontax considerations, thereby increasing risks of financial distress and bankruptcy." *Integration of the Individual and Corporate Tax Systems*, Report of The Department of the Treasury, January 1992, p. 1.

² See The American Business Conference, *Capital Gains, Economic Growth, and Jobs*, 1992, esp. pp. 10-12.

Real World Consequences

Concepts such as the double taxation of saving and the cost of equity capital are abstract ideas that nevertheless have real world consequences. The level of saving drives productivity improvements and, therefore, increases in the standard of living. The quantity and cost of equity capital affects the growth and level of job creation of entrepreneurial ventures, particularly in knowledge-based industries, such as, for example, high technology.

Lowering -- or eliminating -- the capital gains tax is an excellent incremental step toward addressing our tax code's anti-saving, anti-equity-capital bias. *It is a good start, in other words, toward reorienting our tax system toward encouraging growth, entrepreneurship, and a higher standard of living.*

We are not political leaders and are therefore wary about describing ideal capital gains legislation. We would, however, like to express some general ideas which we respectfully hope you will consider as legislation is written.

- Our strong preference is for broad-based legislation. We believe "targeting" capital gains relief toward particular types of companies would further contort an already distorted tax code.
- Additionally, we think there is much merit to indexing capital gains so that only real gains are ultimately taxed.
- Finally, we would encourage you to consider a capital gains "rollover" by which the tax on realized gains is deferred if the gains are reinvested in new equities. The idea here is to "unlock" old investments while encouraging the newly realized gains to remain in the national saving pool.

We hope this letter will be of use to you as the debate over capital gains taxation intensifies in the months ahead. If you have any questions about this letter or seek elaboration on any of the points it makes, please let us know.

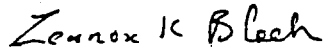
Sincerely,



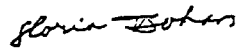
Richard Syron
Chairman & CEO
American Stock Exchange
New York, NY
and
Chairman, American Business Conference



John W. Ballard
President
TCI International, Inc.
Sunnyvale, CA



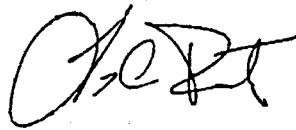
Lennox K. Black
Chairman & CEO
Teleflex Incorporated
Plymouth Meeting, PA



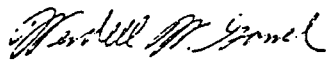
Gloria Bohan
President
Omega World Travel, Inc.
Fairfax, VA



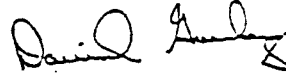
John W. Brown
Chairman, President & CEO
Stryker Corporation
Kalamazoo, MI



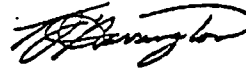
Lynn C. Fritz
President & CEO
Fritz Companies, Inc.
San Francisco, CA



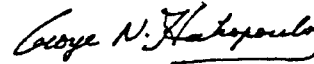
Wendell W. Gamel
Chairman & President
Tech-Sym Corporation
Houston, TX



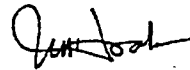
Daniel Greenberg
Chairman & CEO
Electro Rent Corporation
Van Nuys, CA



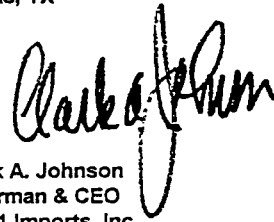
Thomas J. Harrington
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George N. Hatsopoulos
Chairman & CEO
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Waltham, MA



James M. Hoak
Chairman
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Fort Worth, TX



Kay Koplovitz
Founder, Chairman & CEO
USA Networks
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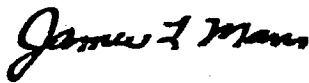
Mame Oberauer, Jr.
Chairman & CEO
Devon Group, Inc.
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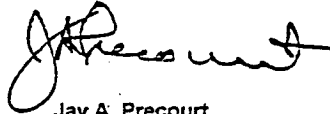
Eric Krasnoff
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Spencer Stuart
Stamford, CT



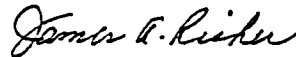
James L. Mann
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Jay A. Precourt
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Tejas Gas Corporation
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Richard A. Manoogian
Chairman & CEO
Masco Corporation
Taylor, MI



James A. Risher
President & CEO
Exide Corporation
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Mayo A. Shattuck III
President & COO
Alex. Brown Incorporated
Baltimore, MD



Barry K. Rogstad
President
American Business Conference
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Alfred P. West, Jr.
CEO
SEI Investments
Oaks, PA

Mr. ENGLISH. Thank you.

Mr. Wiggans, I very much appreciated your testimony and your reference also to the targeted capital gains bill that Mr. Matsui and I have been promoting. I wonder if you could amplify on your remarks and talk about how the capital gains tax affects entrepreneurs who are trying to enter capital markets, trying to finance innovations in the economy, and recognizing that their ventures involve a fair amount of risk, How does the capital gains tax affect people in your situation and your ability to attract investors?

Mr. WIGGANS. Well, first of all, let me thank you for your support of these bills, because as I mentioned, they do seem to be the solution to some of these issues. Let me simply say that the investments that investors need to make in companies like mine are unique. It requires patient capital; it requires locked-up capital. As you pointed out, it is high risk capital. So, it is a very unique type of investment that should correspond with a different tier or a different type of incentive.

Investors who originally made an investment in my company or any biotechnology company for that matter must be willing to not only risk that capital but at a minimum, have it locked up for extended periods of time. There is no liquidity to venture investments. If you invest in General Motors today and decide you have changed your mind, you can sell it tomorrow. The founding investors, the founding venture capitalists in my company, cannot get their capital out. They are locked up for years and years. So, I hope that answers your question.

Mr. ENGLISH. That does, and I am grateful for that answer, because it speaks directly to one of my concerns about the capital gains tax, that it falls disproportionately on those parts of our economy and even those communities, such as depressed, inner-city areas that are least able to attract investment because of the risks associated with it.

Mr. Bloomfield, I wonder, following through on this line of questioning, in your view, is a capital gains incentive more important to small businesses than to large businesses, and, in your view, why?

Mr. BLOOMFIELD. I do not think there is any doubt that companies like Mr. Wiggans' may have more difficulty attracting capital, but I think the extent to which we reduce overall capital costs has big macro impact, which helps the economy as a whole, in addition to certain segments. But if you talk about the concerns Mr. Wiggans has about finding scarce capital, I am not sure how many of you have seen this interesting article that appeared in the Wall Street Journal about 2 or 3 weeks ago called Found Money. When David Wyss refers to the fact that he would take a finder's fee for finding \$50 billion, in other words, this is the true free lunch. What this article in the Wall Street Journal suggests is we really have a lot of locked up capital in the markets now that may not be reflected in a lot of the revenue estimates. Let me give you an example: In the period 1982 to 1985, realizations as a percentage of the total value of equities in the United States were between, let's say, 5 and 8 percent in that period. The stock market at that time, or the value of equities, was about \$2.2 trillion.

If you go a decade later, to 1995, you will find that realizations as a percentage of total value of equities was not between 5 and

8 percent but only 2 percent. If you apply that same ratio of realizations, and you say that realizations should have been at 7 percent, instead of revenues coming to the Treasury in the range of \$40 billion, revenues would have been \$70 billion. And when I am talking about the value of equities being, in 1995, about \$7 trillion, they are now \$9 trillion.

What I am basically saying is that there is a heck of a lot of locked up capital out there which might be unlocked which, I think, would change a lot of the equations about the revenue impact. That unlocking would provide capital for all Americans but in particular would help capital-starved, risky enterprises like Mr. Wiggans.

Mr. ENGLISH. I wonder: Directed to all of the panelists, and this will sound like, perhaps, an unusual question, Are any of you familiar with the tax treatment under the capital gains tax of dairy cows? Are any of you familiar with it? I must say, 2 years ago I had a new conference with a dairy cow in my district named Bonnie, since deceased. No causal connection, I might add. [Laughter.]

Mr. ENGLISH. And I had discovered that dairy cows are taxed as a capital gain at sale unless they are slaughtered. And what typically happens in a situation like we are experiencing now in northwestern Pennsylvania, where a lot of dairymen are under enormous economic pressure, they are selling some of their stock, and on tax day, they are getting slaughtered. So, stipulating that the capital gains tax has, in many ways, unforeseen and unpredictable effects on different parts of the economy and given that, perhaps, the equity issues associated with capital gains are not as clear cut as they frequently seem to be in debate, I wonder if each of you could offer observations as to what types of individuals and businesses would most benefit from a capital gains tax reduction, starting perhaps with Mr. Wiggans.

Mr. WIGGANS. Well, I would point out that in the biotechnology industry, it is very common practice to give all employees stock options. Even the largest biotechnology company, Amgen, still gives stock options to every single employee. In many cases, that is in lieu of pension plans. So, your sweat equity and your stock option equity are your retirement plan. So, if I could focus, maybe, my answer on that specific segment, from top to bottom in the company, from the highest paid to the lowest paid, stock options are a tremendous incentive economically, and the capital gains changes that you have contemplated would have, I think, tremendous impact on these employees.

Mr. ENGLISH. Mr. Woodbury.

Mr. WOODBURY. In the real estate industry, there are several groups that might very well benefit. One is the most creative people, because they will be the ones who will create the projects that will end up with the most profit and the most gain. And I think you do, as a matter of public policy, want to reward those people who are creative and who produce value for your economy.

Contrary to popular belief, our statistics show that there are a large number of middle-income tax payers who hold real estate capital assets, investment assets. Twenty percent, I think, of those who report adjusted gross incomes under \$50,000 a year hold real estate investment assets, and more than 30 percent of those who

report income between \$50,000 and \$100,000 hold investment real estate assets. So, I think that it would be a broad-based application to middle-income tax payers.

Last, it would help—and this is the locking effect that people are referring to—people, probably, who have held assets for a long time, who have run out of ideas; who are lazy. They are just holding them because they do not know what to do with them, and they do not want to pay the tax. By reducing the capital gains tax, having a broad-based cut, I think it would allow these people, motivate these people to sell, and it would put those assets, again, in the hands of people who would maybe renovate and improve the assets, which would increase the value to the whole economy.

Thank you.

Mr. ENGLISH. Mr. Wyss.

Mr. WYSS. I would divide it into three categories, beginning with corporations. On the corporate side, what the capital gains tax does is makes it more difficult to acquire capital. Therefore, it penalizes the companies that are growing the most rapidly and the companies that need the capital in order to expand. I do not think it is primarily big companies versus small companies; it is growing companies versus static companies.

On the individual side, we do have to accept the fact that, on average, the rich have more capital than the poor. The tax cut is biased toward the high end of the income spectrum. That is reality. It does not mean the poor lose; it just means they do not gain as much as the wealthy. One exception to that is the housing deduction, and I think this is a critical point for the elimination of capital gains on housing, because you are now hitting that time when the baby boomers are getting rid of their kids. Maybe I am speaking too much as an individual, but all I know is that my kids are both gone; my wife and I share a bedroom; the cat does not need the other four bedrooms. But I am not going to sell the house because I do not want to pay 28 percent on the sale value of that house, nor do I want to find a condo downtown that is worth as much as my current house is.

That unlocking of capital is almost free. We are collecting almost no revenue on it now, because I am not selling the house. And why do we not use that capital a little more productively than having the empty bedrooms.

Mr. ENGLISH. Ms. Gravelle.

Ms. GRAVELLE. Well, I think the data show that there are two kinds of assets that are responsible for virtually all the capital gains taxes: Corporate stock and real estate. Those shares fluctuate depending on how the stock market versus the real estate market is doing. Right now, I think the big fraction is in corporate stock. Most corporate stock is issued by large corporations; therefore, most of the capital gains tax cut would have to do with the owners of shares of large corporations.

You mentioned earlier small businesses. A lot of small businesses are not incorporated, so they would not have an effect. And, of course, small businesses issuing new shares are already eligible for a 50-percent exclusion. So, I would say basically, large corporations, and although many middle-income people have shares in

large corporations, the assets, particularly equity assets, are concentrated at the higher end of the scale.

Mr. ENGLISH. Mr. Bloomfield.

Mr. BLOOMFIELD. Mr. English, I would make four points. The first point is, Who owns capital assets. And, as I indicated, CBO points out that 31 percent of people with incomes of \$20,000 or below actually have capital assets excluding their home. If you talk about from zero to \$50,000, you get an even higher amount. So, a lot of middle-class people have capital assets.

The second point I would make is, When the Joint Committee or CBO occasionally talks about income distribution, they may artificially inflate a person's income because he may have once or twice or three times in his lifetime have a capital gain.

Mr. ENGLISH. On that point, Mr. Bloomfield, I understand that roughly 44 percent of the people who pay the capital gains tax have had only one realization during the prior 5-year period. Does that suggest to you that many of the people who pay the capital gains tax in fact are not large investors but individuals who have a single asset, which they sell, that puts them temporarily in a different income category?

Mr. BLOOMFIELD. I think that data is true, and there is even more recent data by CBO which looked at people with an income of \$50,000, and they only had a capital gain 3 out of 10 years. So, people do occasionally have capital gains, and a lot of people have capital gains.

The third point I would make is David Wyss' point about who benefits. In reference to Ms. Gravelle's comment about corporate stock, the Investment Co. Institute recently released data that indicated of those people with incomes of \$50,000 or less, 60 percent of those families have mutual funds. So, we are talking about a growing percentage. Mutual funds as a percentage of capital gains realizations, quite frankly, is one sector that has grown dramatically, from 3 percent of all capital gains to 13 percent. So, individuals benefit from capital gains and capital gains reduction because of their pensions.

Second, there are a lot of people who have dairy cows or other small businesses who benefit because of the tax treatment of their investment in small businesses. And finally, which is also very, very important, as Dr. Wyss pointed out, the average American benefits from the higher productivity of a lower tax on capital. Finally, Mr. English, unfortunately, I do not have any personal knowledge of dairy cows, but I did read in the paper the other day about a painter who said that he supported a capital gains tax cut because he had never been hired by a poor person. And so, I think both directly, in terms of what they own, or indirectly, because of its economic impact, all Americans benefit from a lower tax on capital or capital gains.

Mr. ENGLISH. Thank you. One final question I would like to pose to the entire panel, and it has to do with the fact that we are contemplating with limited revenue opportunity, perhaps, a capital gains reduction this year as part of an overall tax package. I wonder, starting again with Mr. Wiggans, in summary, in your view, What are the most important issues for the Committee to keep in mind in designing a capital gains reduction?

Mr. WIGGANS. I guess I would answer it two ways. I think the macroeconomic data on the productivity and the job creation and the benefits of a broad capital gains tax is clearly one set of issues. I would then focus on the specific issues associated with the capital required to fund small, emerging companies; the technology generated, and the innovation in those small companies; the new therapies, life-saving therapies in many cases, is the second category.

So, clearly, there are macroeconomic benefits. I think those situations at least here seem to be well documented. The targeted gains for emerging companies where the innovation occurs, where biotechnology companies bring new therapies forward, there is also the human element of that, the very real human element of that in addition to the economic benefit.

Mr. ENGLISH. Mr. Woodbury, which issues would you like us to keep in the front of our minds as we consider capital gains tax reduction?

Mr. WOODBURY. As I said in my testimony, we feel there are two basic criteria. One is that, besides the principal residence proposal, which we think is a separate issue and is a simplification issue more than anything else, we believe the capital gains reduction should be broad based and apply equally to all industries and then, let the private sector determine, based on a risk-reward basis, where to put that capital. It should also have enough differential between the ordinary income tax rate to provide an incentive, and I think several of the bills, H.R. 14, the 50-percent reduction, is a broad enough basis to provide that, and those are the two criteria.

Mr. ENGLISH. Thank you, Mr. Woodbury.

Dr. Wyss, what issues should we keep first and foremost?

Mr. WYSS. Well, first of all, I am very much in favor of keeping the tax law simple. Getting rid of the capital gains on housing as much as possible is a good step in that direction, since that is a complication which yields no revenue. But on the rest of the capital gains, I would also tend to echo the same sentiments of the previous speaker: Keep it simple by keeping the same rate across the board, and let the market decide where the money should go rather than to try to target capital gains in a way that favors one sector over another.

Mr. ENGLISH. Ms. Gravelle.

Ms. GRAVELLE. Well, I do think one thing the Committee ought to be very careful about is to pay attention to the revenue costs of these proposals. As I indicated at the beginning and ending of my testimony, the Joint Tax Committee already includes a very generous dynamic offset for capital gains, and there has been some recent evidence that suggests that even that offset may actually be too large. And if we add to the deficit, I think we are doing it in a way that is very costly for savings.

The other important thing is to keep track of the cost over time, because even though you might have a realizations response or possibly even an asset response, that is a transitory effect, and these provisions will likely cost much more revenue in the future. I think it is very important to have a longtime horizon; look out beyond 5 years and to try to think about the future. That is particularly true

if you talk about prospective capital gains tax cuts, such as indexing or exclusions for any new assets that tend to grow very fast.

So, I think the revenue issue, as we all know, is a very important one to pay attention to, and I think there are lots of issues. There are issues of equity, efficiency, and simplicity. But I do urge you to not forget about simplicity along the way and, in particular, the efforts of some kinds of tax changes. For example, indexing would be much more complicated than an exclusion in terms of tax compliance. I think those are issues that tend to get swept aside sometimes, and they are sort of important to remember.

Mr. ENGLISH. Thank you.

Mr. Bloomfield.

Mr. BLOOMFIELD. Mr. Chairman, let me suggest three areas that you ought to look at to make sure or to increase the odds that you will enact a sensible capital gains tax cut. The first issue is one of being fiscally responsible, and I do not think there is any doubt, none of us here or none of those on this Committee would want to do anything that would be fiscally irresponsible. I think David Wyss and others have indicated that this is one of those few tax cuts that is a free lunch.

I would point out, with some disagreement with Ms. Gravelle, it is true that the Joint Committee does take into account the unlocking factor. It takes into account the reclassification of income from ordinary into capital gains. But it does not take into account the macroeconomic impact of a higher GDP, nor does it take into account the impact of higher asset values. If you look at a mainstream economic model like Alan Sinai's or DRI—take, for example, the Hatch-Lieberman bill—what you would find is a revenue gain in the range of between \$8 billion under David Wyss' analysis and up to \$40 billion under Alan Sinai's.

So, I think you need to look at that, and I think that is a fair way to look at capital gains. You need to be revenue responsible. I do not think you are going to lose money, and you might pick up money.

Second, I think you need to be fair, and by being fair, I do not think you should favor one asset over another. I would encourage you to make sure the dairy cows of your congressional district are eligible assets, as well as the new biotech developments in Silicon Valley.

And finally, a proposal needs to make economic sense, and to do so, it needs to meet only four criteria: You should reduce the capital costs, encourage the mobility of capital, prevent the taxation of inflationary gains, and you ought to encourage entrepreneurship. If you meet those four criteria, you are doing something worthwhile. I would caution, however, if you do not meet those criteria, or the tax cut is so small it is negligible, a capital gains tax cut in name may not be worth much in reality.

Mr. ENGLISH. Thank you, Mr. Bloomfield, and I want to thank the entire panel for providing this very enlightening, diverse, and extremely—in each case—thoughtful testimony. I appreciate, really, the responses you provided, because I think they point the way for this Committee to make some significant changes, hopefully this year, in the Tax Code that will create new incentives for in-

vestment back into the economy and hopefully unlock assets that could be more productively used elsewhere.

In my view, this is a very important issue, and we very much appreciate the contribution this panel has made to our deliberations. With that, without objection, I am going to recess the panel until 1:05 p.m.

Thank you.

[Whereupon, at 12:32 p.m., the Committee recessed, to reconvene at 1:05 p.m., the same day.]

Chairman ARCHER [presiding]. The Committee will come to order.

The Chair apologizes to our witnesses for being 5 minutes late, but hopefully, that is good enough for government work.

We are happy to have you with us today, and we look forward to the testimony from each one of you.

Mr. Whelan, would you lead off, identify yourself for the record—

Mr. WHELAN. Yes, sir.

Chairman ARCHER [continuing]. And then you may proceed.

Hopefully, all of you will limit your oral testimony to 5 minutes, and your entire printed statement will be inserted in the record.

STATEMENT OF MARTIN J. WHELAN, PRESIDENT, ETTLINE FOODS CORP., YORK, PENNSYLVANIA; ON BEHALF OF FOOD DISTRIBUTORS INTERNATIONAL, FALLS CHURCH, VIRGINIA

Mr. WHELAN. Good afternoon, Mr. Chairman and Members of the Committee. I am Martin Whelan, president of Ettlina Foods Corp., a privately owned distributor of food service products located in York, Pennsylvania's, 19th District, and a member of Food Distributors International.

At the request of the Committee, I will limit my testimony to a few short minutes. Food Distributors International has provided the Committee with my written comments, which we would like to appear in the official record of this hearing.

Mr. Chairman, I am very pleased to have the opportunity to appear before you today to discuss estate taxes which the food distribution industry prefers to call death taxes. I commend you for holding these hearings on this very important subject matter.

You may recall that one of my colleagues in the food distribution industry, William Eacho, had the opportunity to testify before this Committee during the 104th Congress on the same issue, and our message remains the same: The tax should be repealed.

Ettlina Foods Corp. is a privately owned distributor of food service products. Ettlina was founded in 1889 by Oscar Ettlina and was at that time a general store whose customers were farmers and local people. Today, 109 years later, the company is a broad-line food service distributor, serving over 1,300 customers in three States. Our customers are restaurants, institutional food service users, and grocery and convenience stores.

Over the years, Ettlina has remained a family owned and operated company. My family purchased the company 8 years ago, following the retirement of Doyle Ankrum, and we became the fourth family to own this business. When I purchased Ettlina in 1989, the

company employed 48 people. I am very proud to say today, we employ 105 people.

My family has reinvested all of our aftertax profits into facilities, equipment, and working capital. Additionally, I have chosen to limit my compensation in order to support the growth of the business. Over the past 2 years, we have invested approximately \$4.5 million in additional capital, and as a result of all these efforts, we have more than doubled the sales volume of our business and added more than 20 full-time employees to our payroll.

Mr. Chairman, there is a very personal reason for my being interested in the death tax issue. I have a terminal illness that mandates constant planning for the managerial succession of my business and the financial security of my family after my death.

As a result, I spend several thousand dollars each year to keep on retainer an estate tax lawyer and a tax accountant who assist in keeping me abreast of any changes in tax regulations, as well as reviewing changes in my company's assets.

I cannot help but feel that this is a nonproductive use of assets. It could be used to continue to grow the business and create more jobs in York. Estate planning is a time-consuming and expensive process. However, in my case, it is a very necessary process.

Yet, when all is said and done, I still worry knowing that, after all this money and effort, the continuity of my family's business continues to be at risk.

I have four children, three of whom are still in college. One of my children has expressed an interest in working in the family business, and I want to ensure that if my daughter so chooses, she inherits a financially sound company.

If at my death Congress has yet to act on this issue, my company's capital structure may very well be impaired, causing at best the stagnation of Ettlne, and at worst, the demise of my family business and the loss of a significant number of jobs.

Privately held independent businesses are the backbone of our free enterprise system. Small businesses, which for the most part are family owned, are where two-thirds of all new American jobs are currently being created.

Therefore, it is ironic to me that the Federal Government would penalize family owned businesses with an unfair and confiscatory tax. If small businesses are so important to the growth of this Nation, then companies such as mine should be on a level playingfield with larger public companies that are not subject to estate or death tax burdens.

President Clinton in his budget proposal provides estate and gift tax relief. However, in my opinion, his proposal falls short of ensuring that privately held family owned businesses, such as my own, will be able to survive being passed on to future generations.

Earlier during this hearing, we heard arguments for reducing the capital gains tax rate. While the food distribution industry certainly supports reducing the capital gains tax rate, we point out that there is an even greater justification for lowering the death tax rate. I say that because capital gains are realized through the voluntary sale of a business or other asset. Whereas, estate transfers are the result of a death, which is involuntary.

I am not a wealthy man. I sit before you today, a humble man from York. In my business, the days are long, the work is hard, the profits are slim.

When I bought my company 8 years ago, I also bought a piece of the American dream. I would like to think I represent what is still good about this country of ours, the spirit of entrepreneurship and hard work. With the low profit margins in our industry, Ettlina is simply not liquid enough to be able to pay this burdensome tax. At a top tax rate of 55 percent, my family and many others would simply be unable to maintain the continuity of the business.

With the small amount of revenue that is generated by the tax, the economic devastation hardly seems worth it. The death tax costs the government and taxpayers almost as much in administrative and compliance fees as it raises in revenue.

I am not only concerned for the well-being of Ettlina and our employees, but also the hundreds of family owned restaurants and mom-and-pop grocery and convenience stores who are my customers. I would be remiss if I did not commend those lawmakers here in the House who have introduced legislation to repeal the Federal death tax.

The food distribution industry applauds their tough stand against this onerous tax. It is my understanding that Members of this Committee are working together to craft bipartisan legislation that provides significant relief from death taxes by using a three-pronged approach: Increasing the unified credit, providing a special family business carve-out, and reducing the estate tax rates. Of these three approaches, it is obvious that rate reduction is the only true and viable approach that is on the path to full repeal.

Therefore, short of repeal, the food distribution industry strongly urges this Committee to rally its support around this type of approach. I strongly believe it is incumbent upon this Congress to enact meaningful death tax relief legislation this year. To do otherwise is simply unconscionable. However, by doing so, this Congress would be sending a message to the American people that recognizes the importance of family owned business and the contributions that they make to this great Nation.

The future of Ettlina's employees and the millions of employees of other family owned businesses rest in your hands.

Thank you for having me here, and I look forward to answering your questions.

[The prepared statement and attachment follow:]

Statement of Martin J. Whelan, President, Ettlina Foods Corp., York, Pennsylvania; On Behalf of Food Distributors International, Falls Church, Virginia

INTRODUCTION

Good morning, Mr. Chairman and members of the Committee, I am Martin J. Whelan, President of Ettlina Foods Corporation and a member of Food Distributors International. I am very pleased to have the opportunity to appear before you today to discuss estate taxes, which the food distribution industry prefers to call death taxes.

I commend you, Mr. Chairman, for holding these hearings on death taxes, as well as the other savings and investment provisions included in the Clinton Administration's Fiscal Year 1998 budget proposal. You may recall that one of my colleagues in the food distribution industry, William Eacho, III, had the opportunity to testify

before this Committee last Spring, during the 104th Congress, on the same issue. Our message remains the same—the death tax should be repealed.

BACKGROUND ON FOOD DISTRIBUTORS INTERNATIONAL

Food Distributors International (FDI), the group that represents the interests of Ettline Foods Corporation in Washington, DC, is an international trade association comprised of food distribution companies which primarily supply and service independent grocers and foodservice operations throughout the United States, Canada and more than 20 other countries. FDI's 266 member companies operate 1139 distribution centers with a combined annual sales volume of \$142 billion. Their members employ a work force of over 350,000 and, in combination with their independently owned customer firms, provide employment for several million more people.

Roughly 30 percent of FDI's members are small, privately held family-owned businesses. They provide employment for over 22,000 people, and have a combined annual sales volume of over \$7.5 billion. These businesses, along with FDI's other member companies, supply and service thousands of family-owned grocery stores and restaurants across the country.

FDI is also a member of the Family Business Estate Tax Coalition, which is made up of approximately 100 organizations who support the elimination of the estate tax. I have attached an ad on the death tax that FDI placed in the March 3rd edition of The Washington Times.

BACKGROUND ON ETTLINE FOODS CORPORATION

Ettline Foods Corporation is a privately owned distributor of foodservice products, located in York, Pennsylvania. Ettline was founded in 1889 by Oscar Ettline, and was at that time a general store whose customers were farmers and local people. Today, 109 years later, the company is a broadline foodservice distributor serving over 1,300 customers in three states. Our customers are restaurants, institutional foodservice users, and grocery and convenience stores.

Over the years, Ettline has remained a family-owned and operated company. The Whelan family purchased the company 8 years ago, following the retirement of Doyle Ankrum, and became the fourth family to own the business. When I purchased Ettline in 1989, the company employed 48 individuals. I am proud to say that today we employ 105 people.

My family has reinvested all of the after-tax profits into facilities, equipment, and working capital. Additionally, I have chosen to limit my compensation in order to support the growth of the business. Over the past two years, we have invested approximately \$4.5 million in additional capital and, as a result of all of these efforts, have more than doubled the sales volume of our business and added more than 20 full-time employees to our payroll.

Ettline's number one goal for 1997 is to give all of its employees the opportunity to exercise their skills, and to provide training and continuing education so that they are able to advance their careers. At Ettline, we strive to create a family-oriented environment, by holding such annual activities as an Easter egg hunt, a company-wide picnic, and an end-of-the-year holiday party. All of our employees are encouraged to bring their entire families and to participate in these events.

At Ettline, we also believe it is important to give something back to the community that has supported our business over the years. Therefore, we encourage our employees to become involved in community-based activities. Of the many things that Ettline quietly does within the community, I would like to mention that each week my company contributes its excess inventory to the York City Food Bank. I am also a board member of Our Daily Bread, a soup kitchen located in York.

THE NEED FOR ESTATE/DEATH TAX RELIEF

Mr. Chairman, there is a very personal reason for my being interested in the death tax issue. I have a terminal illness that mandates constant planning for the managerial succession of my business, and the financial security of my family after my death. As a result, I spend several thousand dollars each year to keep on retainer an estate tax lawyer and a tax accountant, who assist in keeping me abreast of any changes in tax regulations, as well as reviewing changes in my company's assets.

I cannot help but feel that this is a non-productive use of assets that could be used to continue to grow my business and create more jobs in York. Estate planning is a time-consuming and expensive, but—in my case—necessary process. Yet, when all is said and done, I still worry knowing that all of this prudent planning will not

alleviate my heirs of a heavy tax burden, and that the continuity of my family's business is at risk.

I have four children—ages 25, 22, 21 and 20, three of whom are still in college. One of these four children has expressed an interest in working in the family business, and I want to ensure that, if my daughter so chooses, she inherits a financially sound company.

Unfortunately, if we do not act now to provide family-owned businesses substantive relief from the death tax, my daughter just might be unable to move our company forward in the next millineum. If, at my death, Congress has yet to act on this issue, my company's capital structure may very well be impaired, causing, at best, the stagnation of Ettline and at worst the demise of my family business and the loss of a significant number of jobs.

We continue to hear that privately held, independent businesses are the backbone of our free enterprise system. Small businesses, which for the most part are family-owned, comprise 99 percent of the private sector, employ 60 percent of all working Americans, and are responsible for 50 percent of gross domestic product and 30 percent of U.S. exports. Finally, these small businesses are where two-thirds of all new American jobs are currently being created.

Therefore, it is ironic to me that the federal government would penalize family-owned businesses with this unfair, confiscatory tax. It would seem to me that if small businesses are so important to the growth of this nation, then companies such as mine should be on a level playing field with larger public concerns—companies that are not subject to estate/death tax burdens.

According to a letter Senator Phil Gramm sent to an FDI member, unless we achieve significant changes in the estate tax law, this nation “will be put in the position where virtually every family farm and every family business would have to be sold or severely penalized to pay taxes on wealth that has been built up over the years with after-tax income.”¹

THE DISINCENTIVE EFFECTS OF THE ESTATE/DEATH TAX

Mr. Chairman, the food distribution industry agrees with your statement—in announcing these hearings—that an overhaul of the current tax system would provide “a more lasting way to encourage savings and investment and produce a stronger economy, and that until that goal can be reached, we should enact changes to our tax system that reduce disincentives to save and invest.” I am glad we agree that the death tax provides such a disincentive.

President Clinton, in his Fiscal Year 1998 budget proposal, provides estate and gift tax relief by increasing the amount of property eligible for a favorable interest rate on deferred estate tax, and eliminating certain distinctions based on form of ownership. In my opinion, the President's proposal falls short of ensuring that privately held/family-owned businesses, such as mine, will be able to survive being passed on to future generations.

I was raised to believe that hard work would be rewarded. How can—in good faith—instill that same message in my children, when I know that upon my death the government will, in effect, confiscate the value of my lifetime of work? Is that how I am to be rewarded? Is that really the message this Congress wants to send to America's aspiring entrepreneurs? Believe me, I am not searching for a “hand out,” I just want the ability to pass down to my heirs—unencumbered—what is rightfully theirs.

Earlier during this hearing, we heard arguments for reducing the capital gains tax rate. And while the food distribution industry certainly supports reducing the capital gains tax rate, we point out that there is an even greater justification for lowering the death tax rate. I say that because capital gains are realized through the voluntary sale of a business or other asset, whereas estate transfers are a result of death, which is involuntary. Simply put, Mr. Chairman, death taxes steal from America's family-owned businesses.

IMPACT OF ESTATE/DEATH TAXES ON SMALL BUSINESSES

Since last year, I believe we have made significant headway in dispelling the notion that death taxes affect only the wealthy. We cannot afford to let demagoguery and class warfare overshadow the merits of reducing a tax that kills. This issue is far too important to succumb to those sorts of attacks.

I am not a wealthy man. I sit here before you today a humble man from York. In my business, the days are long, the work is hard, and the profits are slim. When

¹Letter from Senator Gramm to member of Food Distributors International.

I bought my company 8 years ago, I also bought a piece of the American dream. I would like to think that I represent what is still good about this country of ours—the spirit of entrepreneurship and hard work.

The food distribution industry as a whole is not a particularly “wealthy” industry. It is important to note that in 1995, profits before tax as a percent of sales for foodservice distributors were only 2.2 percent—the highest level since 1987. This measure for wholesale grocers was 1.3 percent—down from 1.6 percent in 1994.² Similarly, the profit margin in the restaurant and grocery business is also narrow.

Again, as I stated earlier, my family has invested all of its after-tax profits into facilities, equipment, and working capital. It is commonplace for companies such as mine to reinvest their profits into the business, in order to grow that business. Most small businesses would be unable to survive without the reinvestment of profits.

Therefore, it should become painfully clear that businesses such as Ettlne are simply not liquid enough to be able to pay this burdensome tax. At a top tax rate of 55 percent, my family—and many others—would simply be unable to maintain the continuity of the business.

For the small amount of revenue generated by the death tax (approximately one percent of all federal revenues), the economic devastation hardly seems worth it. Furthermore, the death tax costs the government and taxpayers almost as much in administrative and compliance fees as it raises in revenue. To be more precise, these fees account for 65 percent of every dollar collected.

I would like to make it clear that I am not only concerned for the well-being of Ettlne and our employees, but also the hundreds of family-owned restaurants and grocery and convenience stores who are my customers. These businesses rely upon Ettlne to supply their needs, and their customers—the American people—rely on them for the food they eat everyday.

CONCLUSION

I would be remiss if I did not commend Representatives Christopher Cox, Phil Crane, Wally Herger, Amo Houghton, Kenny Hulshof, Bob Livingston, Mike Pappas, Joseph Pitts, Gerald Solomon, Bob Stump, William Thomas, and William Thornberry³ for sponsoring legislation to repeal the federal death tax. The food distribution industry applauds their tough stand against this onerous tax.

It is my understanding that members of this Committee are working together to craft bipartisan legislation that provides significant relief from death taxes by using a three-pronged approach: increasing the unified credit, providing a special family-business carve-out, and reducing the estate tax rates. Of these three approaches, it is obvious that rate reduction is the only true, viable approach that is on the path to full repeal. Therefore, short of repeal, the food distribution industry strongly urges this Committee to rally its support around this type of approach.

As I previously mentioned, a colleague of mine testified on this issue during the 104th Congress. On behalf of the food distribution industry, he urged lawmakers to enact some form of estate tax relief. As all of you are aware, that did not happen. It would be a shame if we let another year go by without addressing this problem.

Again, short of repeal, I strongly believe it is incumbent upon this Congress to enact meaningful death tax relief legislation this year—to do otherwise is simply unconscionable. However, by doing so, this Congress would be sending a message to the American people that it recognizes the importance of family-owned businesses and the contributions that they make to this great Nation.

The future of Ettlne’s employees and the millions of employees of other family-owned businesses rests in your hands.

Thank you for having me. I look forward to answering your questions.

² 1996 Distributor Productivity Financial Report Falls Church, VA: Food Distributors International, 1996

³ Various Estate/Gift Tax Legislation Introduced in the 105th Congress by the following Members of the U.S. House of Representatives: Representative Cox (R-CA)—H.R.902 Representative Crane (R-IL)—H.R.525 Representative Herger (R-CA)—H.R. 64 Representative Houghton (R-NY)—H.R. 195 Representative Hulshof (R-MO)—H.R. 525 Representative Livingston (R-LA)—H.R. 683 Representative Pappas (R-NJ)—H.R. 245 Representative Pitts (R-PA)—H.R. 249 Representative Solomon (R-NY)—H.R. 324 Representative Stump (R-AZ)—H.R. 348 and H.R. 736 Representative Thomas (R-CA)—H.R.495 Representative Thornberry (R-TX)—H.R. 802.

Why Must the Government View Death as an Opportunity?

You've spent a lifetime paying taxes.

Now, the IRS rewards your family, upon your death, by claiming rights to 55% of the business you've worked a lifetime building.

In many cases, estate taxes (we call them death taxes) force the liquidation of family-owned businesses. We ought to support family-owned businesses—the backbone of the Nation's economy.

The food distribution industry urges all lawmakers to join the bipartisan congressional effort to relieve America's family-owned businesses from death taxes.

Death is hard enough on families. . . .

Why should the government add to your family's loss and pain, by confiscating the value of your lifetime of work?



Look for the men and women wearing this button on Wednesday, March 5th, when they will be on Capitol Hill meeting with their lawmakers on this very important issue.

For more information, please call Kevin Burke in the Government Relations department at (703) 532-9400.



Chairman ARCHER. Thank you, Mr. Whelan.

Our next witness is Dan Danner. If you will identify yourself for the record, we will be pleased to have your testimony.

STATEMENT OF DAN DANNER, VICE PRESIDENT, FEDERAL GOVERNMENT RELATIONS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. DANNER. Thank you, Mr. Chairman.

For the record, I am Dan Danner, vice president of Federal Government relations for NFIB, the National Federation of Independent Business.

NFIB represents 600,000 small businessowners in all 50 States. We thank you for the opportunity to testify here today. I will submit longer testimony, but in the brief time I have here, I would like to leave you with three points. First, providing small businessowners relief from the death tax is NFIB's top legislative priority. Second, the proposal in the President's budget is well intentioned but does not go far enough. Third, we encourage Congress to go well beyond the President's proposal in this Congress.

Providing relief now is our top priority. Today, the death tax represents a huge disincentive for growth for family businesses. It means lost opportunities, lower productivity, and fewer jobs. Nearly 60 percent of businessowners report they would add more jobs in the year ahead if death taxes were eliminated. Three out of four family businessowners report that long-term growth is made significantly more difficult or impossible by the death tax.

For those that do attempt to plan well for death taxes, the costs are staggering and often result in cash flow problems and ultimately failure. All of this is why elimination of the death tax was the number four recommendation out of 60 adopted by President Clinton's White House Conference on Small Business, but all of these are just numbers.

Let me mention just two of the many NFIB member stories. Clarence Tart is the owner of a fourth generation farming and lumber business in Dunn, North Carolina. Tart & Tart employs 70 people. He wonders why his family will have to buy back the business from the Federal Government for the fourth time and how his son will ever afford the estimated \$1.5 million tax without eliminating many of the jobs when his son's salary is only \$30,000 a year.

Wayne Williams runs a business that makes fiberoptic equipment in Spokane, Washington. His parents started the business over 15 years ago with nothing and have grown the business to over 500 employees. Williams, who fights along with his parents to remain competitive against Japanese and German rivals, wonders how the astronomical cost of his legal and life insurance fees benefits this country when he sees the beneficiaries as his foreign competitors.

And how do we help these families? The President's proposal does not go far enough. The President's proposal to modify the existing 14-year loan program by lowering the interest rate for closely held businesses is a very small Band-Aid for a very large problem.

Small businesses will still be left with massive debt and huge cash flow problems to pay the death taxes of up to 55 percent.

With the children in a family business who are struggling to buy back half of their own business from the Government, this proposal

is like throwing a life raft to a sinking ship after shooting a hole in its bow. It still results in lower productivity and often failure of the business. That is why family businesses are becoming an endangered species. More than 70 percent do not survive the second generation, and 87 percent do not make it to the third generation. Death taxes are increasingly becoming a death sentence for their businesses.

Finally, Congress should address the death tax in a significant way in this Congress. Certainly, our first choice would be elimination of the death tax. It is the fairest and the simplest method. A tax doesn't make sense, and we should eliminate it.

Short of repeal, we want the most relief possible for family businesses, farmers, and ranchers in this Congress. We need to at least begin the transition toward eliminating the death tax in a meaningful way. Short of repeal, we support increasing the unified credit and reducing death tax rates. We further propose that the value of a closely held business, farm, or ranch, should be exempted from death taxes altogether.

Mr. Chairman, on behalf of the NFIB's 600,000 members, I want to thank you again for the opportunity to testify. There isn't any issue that NFIB members feel stronger about than the death tax and the devastating impact it has on their businesses, the jobs they provide, and the communities they support.

We urge you and the Committee to take real steps now toward elimination of the death tax on family businesses, and we urge the President to consider expanding on his proposal to provide real relief now.

Thank you, and I look forward to your questions.

[The prepared statement follows:]

**Statement of Dan Danner, Vice President, Federal Governmental Relations,
National Federation of Independent Business**

The National Federation of Independent Business appreciates the opportunity to testify on the Administration's 1998 Budget Proposal, and, specifically, the issue of federal death taxes and their impact on small businesses. NFIB is the nation's largest small business organization representing 600,000 small business owners from all fifty states. NFIB sets its public policy positions through regular polling of the membership.

The process the Committee and the Congress is now engaged in presents an historic opportunity to relieve America's small business owners from government-imposed burdens and open the door to economic expansion and job creation in the small business sector. The federal death tax represents perhaps the greatest burden today on our nation's most successful small businesses.

At roughly one percent of annual revenues, this tax is hardly worth the devastation it causes to family businesses and farms, incentives for entrepreneurship, and our nation's international competitiveness. The costs of such damage to small businesses and our nation's economy is unquestionably high.

SMALL BUSINESS: AMERICA'S PATH TO JOBS AND INDEPENDENCE

Evidence continues to suggest clearly that small business plays a rather remarkable role as a job creator and provider of personal opportunity, security and independence for millions of Americans. Consider the following:

Jobs. Since the early 1970s, small firms have created two of every three net new jobs in this country (created jobs minus lost jobs). The nation's small business job machine has shown a capacity to produce in either good or tough times. From 1989 to 1991, a period of minimal economic growth, firms with fewer than 20 employees created all net new jobs in the country. Firms of all other sizes lost employment during that period.

Demographics. Almost all businesses are small businesses. There are approximately five and one half million employers in the United States. About 99 percent

of them are small employers (with under 500 employees), and almost 90 percent employing fewer than 20 employees. Small business as a whole employs more than half of the private sector workforce. Most small firms are not set up as C corps, but as proprietorships, partnerships, and subchapter's corporations.

Values. Small business holds out to our citizens' great hope. Small business offers a road map to the American dream that allows any American with a good idea and talent to follow it to economic freedom and security by starting their own business and working hard to make it a success. And possibly the ultimate American dream is to be able to pass that successful business on to one's children.

Evidence indicates that the vast majority of America's small closely-held businesses are family businesses. Although it is difficult to precisely define a family business, there are clear characteristics of the family business which distinguish it from others. While other businesses are usually driven entirely by return on investment, the family business is most often driven first by other priorities—like relationships and longevity. Family businesses are generally much smaller than publicly-traded corporations, but possess certain advantages over these larger businesses. For instance, being private, family businesses do not have to worry about quarterly earnings reports for stock analysis, and can instead focus on long-term value enhancement, even if it means losing money in the short-term in some cases. Additionally, family businesses operate without a rigid bureaucracy, consequently, they can respond quickly and intuitively to changes in business environments. On the other hand, because of personal considerations, such as a desire to pass the business on to one's children, a family business may not always make purely rational decisions in a market-driven sense. Family businesses play a far greater role in this nation's economy than many might think—estimates indicate that they produce roughly half of our nation's gross domestic product.

THE NEED FOR DEATH TAX REFORM

NFIB considers death tax reform to be crucial to the continued survival of the small American family business. Current death tax rates cripple a small business passed on to heirs, and often force them to liquidate a business they have worked in their whole lives. High death taxes may provide government revenue in the short run, but the long-run losses far outweigh the gains—a productive business is extinguished, many jobs are lost, and the American dream of growing a business and preserving it beyond one's lifetime by passing it on to heirs becomes impossible to achieve.

Because all assets are included in determining death taxes, such as the decedent's home and other personal assets, many productive businesses worth far less than the current exemption level become victims of the death tax. Because so many small businesses operate on cash flow, often with extremely small or negative profit margins, current law allowing small businesses to spread their tax liability over fourteen years does not provide adequate relief. The 1995 White House Conference on Small Business voted death taxes as the fourth greatest problem to small business needing reform.

Small businesses are also particularly vulnerable to the intricacies of death tax law. Although some owners can ensure a successful transfer to heirs by purchasing life insurance and through other methods, many cannot afford this kind of planning or do not have the time to meet with estate planners because most of their energies are directed toward keeping the business running. Unfortunately, unlike a publicly traded corporation, which continues operation regardless of how shareholders plan for their death, a closely held business, unless there has been careful planning, is usually devastated by the death of an owner.

IMPACT ON SMALL BUSINESS

Current death tax rates range from 37 to 55 percent. Faced with the tremendous burden imposed by this tax upon their death, a business owner will react in several of the following ways:

The business owner will not expand the business. Especially in later years of the business owner's life, large capital expenditures for long term growth make little sense when the family will soon be forced to sell or liquidate the business. This disincentive to growth means lost opportunities, lower productivity, and lost jobs. In fact, the existence of death taxes can deter many potential entrepreneurs from starting a business at all.

2) The children will not participate in the business. Knowing that taxes will prevent children from continuing operation of a family business, the business owner will often discourage their children from working in the business and encourage them to gain experience elsewhere. If the children do actively participate in the

business, their experience and knowledge will often go to waste when the business is forced to be sold off. A survey of family businesses by Mass Mutual Life Insurance showed that in 1995 only 57 percent of owners planned on keeping the business in the family, down from 65 percent a year prior; taxes were cited as one of the prime reasons for plans to sell out.

3) The business owner will pay dearly in death planning costs. Even if the business owner has the foresight to plan early for their death, the expense of this planning, in insurance, legal and accounting costs, can be enough to eliminate a business' small profit margin. These extra insurance, legal and accounting costs are especially burdensome because small businesses survive on cash flow, not profit. In an NFIB survey of Small Business Problems and Priorities of NFIB members, cash flow ranked as one of the top ten highest problems for small business. Coming up with the cash to pay bills and make payroll is a constant challenge in a small firm. Money left in the business—cash flow—is the difference between life and death for most new businesses. The costs to small business and society as a whole are high—instead of using these funds to expand, create new jobs, and become more productive and competitive in the international marketplace, small businesses must spend the money on death planning costs.

4) Heirs may not be able to afford tax payments. Despite some planning, heirs are often still imposed with some significant tax burden. Even paid out over time, taxes may be too much of a burden to survive in an internationally competitive marketplace.

FIRE-SALE OF THE FAMILY BUSINESS

What this means is that all too often the family business is sold-off, either before the owner's death or by the estate. Most often, a ready market does not exist for the sale of a small family run business. Consequently, the business is subject to a fire-sale—either liquidated entirely or sold intact for a price far below its true value. Additionally, much of the value of a family business often comes from the experience and know-how of those who run it—the family members. Their stewardship often makes the difference between a profitable, successful business enterprise, and a dying one.

All too often, the family business or farm will be bought-up by a large business such as a corporate conglomerate, at a price that's a fraction of the real value of the business. While the large business may gain some of the assets of the small business, most of the real value of the former business is lost—the entrepreneurial spirit, know-how and ingenuity, the small business' flexibility, and, usually, most if not all of the jobs. What might have become an Apple Computer instead becomes another division of a large cash register sales company.

Contrast this with what happens when a shareholder in a corporation traded on the New York Stock Exchange dies. Because there is a ready market for the stock, the estate can easily sell off enough to pay taxes. The value of that stock does not decline because of the death. Although the stock may have new owners, the operation of the corporation continues completely unaffected by the shareholder's death.

PUBLIC POLICY REASONS FOR THE DEATH (ESTATE) TAX?

The philosophy behind the death tax started with early Americans who were trying to prevent the pooling of too much wealth in too few families, as had occurred in Europe. Today, however, this philosophy is fundamentally flawed. When applied to closely-held business assets, ironically, the tax produces just the opposite result—often forcing family-owned businesses to sell-off to larger public corporations, further concentrating the wealth and power of this country, and encouraging monopolistic controls on markets. This philosophy also ignores the tax's impact on communities that are dependent on these businesses, and its deleterious impact on our nation's international competitiveness against foreign countries like Japan and Germany who do not impose this kind of death tax burden, and who encourage the continuation of family-run enterprises.

THE ADMINISTRATION'S DEATH TAX REFORM PROPOSAL

NFIB appreciates the President's acknowledgment, through his proposal to expand the Section 6166 loan program, that family businesses need relief from death taxes. What our members tell us, however, is that loans to pay exorbitant death taxes do not deliver the kind of relief needed.

The President's proposal would modify existing law, which allows death taxes to be paid over up to a 14 year period and grants a four percent interest rate for taxes attributable up to \$1 million of a qualified closely held business. The 1998 Budget

Proposal drops the interest rate to 2 percent and raises the attributable amount to \$2.5 million, but would make the interest paid on the 14 year loan non-deductible against income taxes. Unfortunately, for the children in a family business who are struggling to buy back half of their own business from the government, this proposal is like throwing a life raft to a sinking ship after shooting a hole in its bow.

We urge the President to work with the Congress to significantly enhance the relief from this tax for America's employers and employees. We believe that this tax should be eliminated altogether. If budget constraints do not allow for that to happen right away, however, it is important to emphasize that America's family businesses and the people they employ need relief from this confiscatory tax *now*. To this end, short of repealing the tax we have supported increasing the unified credit and reducing death tax rates. We further propose that the value of a closely-held family business, farm or ranch be exempted from death taxes altogether.

Exempting closely-held business, farm and ranch assets from death taxes would ensure that the business will continue and that the jobs of its employees will be protected. Moreover, this exemption would eliminate the strong disincentive that now exists for business owners to continue to develop their business and create jobs as they reach their later years in life. A recent study by the Tax Foundation found that today's death tax rates have the same disincentive effect on entrepreneurs as a doubling of current income tax rates.

Total federal death tax revenue represents only about \$15 billion annually. Business assets represent roughly 12 percent of this \$15 billion—about \$1.8 billion a year. In other words, for \$1.8 billion annually, every closely-held farm, ranch, and small business in America could be exempt from the federal tax collector's axe.

By restoring incentives to continue operation of closely-held businesses in the family, this proposal would fuel economic growth in the sector which produces more than half of our nation's gross domestic product. Any loss of revenue by static analysis would likely be more than compensated by a greater tax base in the small business sector.

CONCLUSION

Current death tax rates impose an often overwhelming burden on our nation's small family-run businesses. The small amount of revenue this tax generates is hardly worth the long term damage impacted on these enterprises—in the long run the tax means less economic activity, job loss, and prevention of the continuation and fulfillment of the American dream of operating one's own business and passing it on to one's children.

Eliminating the death tax for family businesses would remove the single greatest government burden imposed upon small family businesses, setting national priorities where they should be: encouraging the continued operation and expansion of family businesses through generations.

Chairman ARCHER. Thank you, Mr. Danner.

Our next witness is Wayne Nelson. If you will identify yourself for the record, we will be pleased to hear your testimony.

STATEMENT OF WAYNE NELSON, PRESIDENT, COMMUNICATING FOR AGRICULTURE, FERGUS FALLS, MINNESOTA

Mr. NELSON. Thank you, Mr. Chairman, Members of the Committee.

My name is Wayne Nelson. I am a farmer from Winner, South Dakota. I am also president of Communicating for Agriculture, a membership association representing farmers, ranchers, and rural small business people in all 50 States.

The estate tax reform is very important to all our members, and especially to me. For years, Communicating for Agriculture has considered meaningful estate tax reform one of our highest priorities. As you well know, heirs wanting to carry on family businesses all too often have to sell land or other assets to pay for Federal estate taxes.

To eliminate or reduce the impact of the estate tax, we have been an active member of the Family Business Estate Tax Coalition for the past 2 years. The coalition represents approximately 80 groups representing more than 6 million owners of family businesses, including farmers, ranchers, and business people. We are very familiar with the various approaches which have been put forth during this time.

Although we salute the President for his initiative in addressing the problem, the solution only extends to the amount of time heirs have to pay the tax. It doesn't address the basic unfairness of the estate tax, which as you know quickly becomes confiscatory.

Delaying the inevitable is not the answer. Repealing or implementing broad-based, meaningful reform is desperately needed.

Just as in urban areas, small family owned businesses are integral to the health of their local economies. We supply jobs. We pay the taxes which support our schools and other public services. We provide the opportunities which help prevent the flight of our children because they can't find work at home. Because our communities are small, every business that shuts its doors sends shockwaves through the area.

We also have to face the issue of age. In my area of South Dakota, the average age of our farmers is 59. This generally holds true across the Nation where the farm population is considerably older than our urban counterparts. What happens when this generation is gone? Who will be there to take over the job of feeding our Nation and much of the world, if not our children?

The estate tax is a slap in the face to a farmer or small business person who devotes every waking hour to building a business and paying taxes, only to have their life's work severely downsized or in some cases even eliminated because of a death tax which quickly reaches 55 percent. It isn't even index for inflation.

Adding insult to injury is that it taxes assets which have already been taxed at least once, and in some cases, twice. Our system layers taxes on top of taxes so we have the highest cost of dying in the world for the farmer and the small business person.

Unfortunately, my own experience is typical. I farmed with my father until his death in 1993. He was confident that his estate plan was adequate to keep the farm operation going and to reduce the estate tax upon his death. Unfortunately, the plan proved inadequate, and the estate owed a great more tax than what we had prepared for. We had to sell several parcels of land to pay the Federal estate taxes.

As most farmers, my father also had existing debt against the land, which meant that more land had to be sold to generate enough cash to help pay this tax.

Consequently, after all this, I consider myself very fortunate to be able to continue farming, even if it is on a more limited scale. Many farmers and small businesses are not so fortunate, and their heirs are forced to cease operations after selling assets to pay these estate taxes. The old saying that farmers live poor and die rich speaks to the great investment we have in the land and the burden of higher values in our estates at the death of owner.

As you know, Congress last addressed the estate tax issue in 1981, raising the exemption to \$600,000. This might have been

enough to cover most small- and mid-sized farms and ranches. That was then and this is now, and now inflation has taken its toll to where \$600,000 today is not what it was 15 years ago.

In many areas of the country, medium-sized and even smaller farms have equity exceeding the \$600,000 exemption. Estate planning can help limit our tax liability, but is very costly and complicated in its own right. Even the best plans are not easily changed if circumstances warrant it.

The added cost of this planning diverts money which should be reinvested in capital improvements and job growth. Many farmers and small business people look to life insurance to pay their estate tax, but this is an expensive option which further diverts money which could have been reinvested in the business.

The irony is that more planning money is spent to prevent family businesses from being destroyed by the estate tax than is actually collected under the law.

The impact of the estate tax has prompted bipartisan support in Congress to remedy the situation. We appreciate the fact that a dozen bills have been introduced in the House and eight in the Senate, which address either repealing or reforming the estate tax.

Mr. Chairman, we in Communicating for Agriculture are hopeful that Congress and the administration can finally address this barrier to America's future prosperity during this session. Please correct this misguided tax policy which has forced many family farms and businesses to cease operation after lifetimes of work, job creation, and support for our communities and Nation through the taxes that we have paid. It isn't fair to our children. It isn't fair to America.

Thank you very much, and we look forward to your questions.
[The prepared statement follows:]

Statement of Wayne Nelson, President, Communicating for Agriculture

Mr. Chairman and members of the Committee. Thank you for asking me to testify today. My name is Wayne Nelson and I am a farmer from Winner, South Dakota. I am also President of Communicating for Agriculture, a membership association representing farmers, ranchers and rural business people in all 50 states. Estate tax reform is very important to all our members and especially to me. For years, Communicating for Agriculture has considered meaningful estate tax reform one of our highest priorities. As you well know, heirs wanting to carry on family businesses all too often have to sell land or other assets to pay for Federal estate and state inheritance taxes. To eliminate or reduce the impact of the estate tax, we have been an active member of the Family Business Estate Tax Coalition for the past two years. The Coalition represents approximately 80 groups representing more than six million owners of family-businesses including farmers, ranchers and rural business people. We are very familiar with the various approaches which have been put forth during this time. Although we salute the President for his initiative in addressing the problem, his solution only extends the amount of time heirs have to pay the tax. It doesn't address the basic unfairness of the estate tax, which as you know quickly becomes confiscatory. Delaying the inevitable is not the answer. Repealing or implementing broad-based, meaningful reform is desperately needed.

Just as in urban areas, small family-owned businesses are integral to the health of their local economies. We supply jobs. We pay the taxes which support our schools and other public services. We provide the opportunities which help prevent the flight of our children because they can't find work at home. Because our communities are so small, every business that shuts its doors sends shock waves throughout the area.

We also have to face the issue of age. In my area of South Dakota, the average age of our farmers is 59. The generally holds true across the nation where the farm population is considerably older than our urban counterparts. What happens when this generation is gone? Who will be able to take over the job of feeding our nation

and much of the world if not our children. This is not an intellectual exercise for us. It's a real issue which we face today.

The estate tax is a slap in the face to a farmer or small business person who devotes every waking hour to building a business and paying taxes only to have their life's work severely downsized or even eliminated because of a death tax which quickly reaches 55%. It isn't even indexed for inflation. Adding insult to injury is that it taxes assets which have already been taxed at least once and in many cases twice. Our system layers taxes on top of taxes so we have the highest cost of dying in the world for the farmer and small business person.

Unfortunately, my own experience is typical. I farmed with my father until his death in 1993. He was confident that his estate plan was adequate to keep the farm operating and reduce the estate taxes due upon his death. Unfortunately, the plan proved inadequate and the estate owed a great deal more tax than we had prepared for. We had to sell several parcels of land to pay the federal estate and state inheritance taxes. As most farmers, my father had existing debt against the land which meant more land had to be sold to generate enough cash to pay this death tax. Consequently, after all this, I consider myself very fortunate to be able to continue farming, even if it is on a more limited scale. Many farmers and small businesses are not so fortunate and their heirs are forced to cease operations after selling assets to pay estate and inheritance taxes.

The old saying that "farmers live poor and die rich" speaks to the great investment we have in the land and the burden of higher valued estates at the death of the owner.

As you know, Congress last addressed the estate tax in 1981, raising the exemption to \$600,000. This was enough to cover most small and mid-size farms and ranches. That was then. This is now. Inflation has taken its toll. \$600,000 today isn't what it was 15 years ago. In many areas of the country, medium size and even smaller farms have equity exceeding the \$600,000 exemption.

Estate planning can help limit our tax liability but it is very costly and complicated in its own right. My father invested in a plan which he thought would work. Even the best plans are not easily changed if circumstances warrant. The added cost of this planning diverts money which should be reinvested in capital improvements and job growth. Many farmers and small business people look to life insurance to pay their estate tax but this is an expensive option which further diverts money which could have been reinvested in the business.

The irony is that more planning money is being spent to prevent family businesses from being destroyed by the estate tax than is actually collected under the law. This makes no sense at all.

The impact of the estate tax has prompted bi-partisan support in Congress to remedy the situation. We appreciate the fact that a dozen bills and have been introduced in the House and eight in the Senate which address either repealing or reforming the estate tax.

Mr. Chairman, we in Communicating for Agriculture are hopeful that Congress and the Administration can finally address this barrier to America's future prosperity during this session. Please correct this misguided tax policy which has forced many family farms and businesses to cease operation after lifetimes of work, job creation and support for our communities and nation through the taxes we've paid. It isn't fair to our children. It isn't fair to America.

Thank you.

Chairman ARCHER. Thank you, Mr. Nelson.

Our next witness is Harold Apolinsky. Mr. Apolinsky has been before the Committee before. We welcome you back again. If you will officially identify yourself for the record, we will be pleased to receive your testimony.

STATEMENT OF HAROLD I. APOLINSKY, VICE PRESIDENT FOR LEGISLATION, SMALL BUSINESS COUNCIL OF AMERICA; AND GENERAL COUNSEL, AMERICAN FAMILY BUSINESS INSTITUTE

Mr. APOLINSKY. Thank you, Mr. Chairman.

Harold Apolinsky. I am an estate tax lawyer from Birmingham, Alabama. I present my testimony on behalf of the American Family Business Institute and its Committee To Preserve the American Family Business and the Small Business Council of America. Our groups come together because of our desire to help family businesses continue within a family.

As I mentioned, I am an estate tax lawyer, an estate planning lawyer. That is what I have been doing for over 30 years. I also teach estate planning and estate gift tax at both the University of Alabama School of Law and the Cumberland School of Law. I have been teaching there for 26 years. Thank you for having me back.

As the Chairman knows, since January 1995, when I first came and appeared before the Small Business Committee and urge that they repeal this estate tax, I have been trying to put myself out of business; close down my estate planning practice. I am running into resistance, however, which either reflects a love of lawyers, which would be nice, because we don't have that back home as much as we should, or a lack of understanding. I think there has been a real awakening which makes me very proud. In the last 2 years I have a better understanding of how this tax works.

I guess we could not have heard a more chilling discussion than what Mr. Whelan just said and how he reviewed the situation. You have heard this morning from Mr. Whelan and others of the damage this tax does. So I really won't dwell on that.

What I would urge, however, is that—and I believe what your Committee does is truly the most important as the constitutionally charged Committee for taxation—that you not enact again a family business carve-out; that you not enact another 2033A as happened in the 1995 Balanced Budget Act. From an estate tax perspective, it was good the bill was vetoed. I am afraid it would have made people feel they had done something really beneficial for family businesses and family farms.

I know people are well meaning. They want family businesses and family farms to continue. They understand this tax keeps them from continuing. I have tried to work for years with 203A which is a farm carve-out that you recall became into the law in 1976. It is the underpinning of 2033A they proposed. In fact, 2033A, as it was originally introduced and made it through the process, incorporates some 12 provisions from the farm carve-out, 2032A. I have devoted quite a bit of my written testimony to an analysis of 2033A. I would urge that you not spend the amount of human capital and resources to work to make something like that useful because it will not ever be useful. It just will not be useful, irrespective of the changes made.

When proposed 2032A was first introduced, one national accounting firm estimated it would benefit some 400 family businesses. I think there are about 100,000 family businesses worth between, say, \$5 and \$100 million nationwide. That would be less than half of 1 percent.

Look at 2032A. The Internal Revenue Service has attacked it often. There have been 134 reported court cases which I have listed in my testimony. The IRS has won most of them. The Commerce Clearinghouse says, appropriately, lawyers are scared to death of this section because of malpractice. I mention it to my students. I

do not teach it. I tell them to be on the lookout for it. It would take an entire semester to teach it.

Passage of 2033A or a similar provision would be great for my business. We looked at the number of family businesses and farms my firm represents. We have eight trust and estate lawyers. We have some 200-such family businesses. For us to explain it, test it, document participation and monitor, we would have to charge about \$15,000 apiece. It would create \$3 million of legal fees for us, which would be great. I think it would probably help me send my grandchildren through professional school, and I am just one firm.

You could easily extrapolate that to 1,000 lawyers. There are 2,600 senior trust and estate lawyers in the American College of Trust and Estate Counsel. I believe you could have \$3 billion of legal fees testing this for less than half of 1 percent of the family businesses and farms.

My hope would be, first, if you could find the money, that you move forward and repeal the death tax. It is the kind of thing you have to hurry. You cannot put it off because someone dies, and that is when the tax is due. If the money is not available, you reduce the tax rate and you raise the tax-free amount. What a great opportunity for simplification. If you could repeal it, you could get the IRS off the back of families. I appreciate it, Mr. Chairman, and applaud your desire to do that.

I have attached a complete report from the Family Business Institute in Kennesaw State. They did a study of equipment distributors and minority owned businesses. They said this thing was counterproductive, significantly limiting economic growth, development, and job creation. They said minority businesses will never grow because they get sliced 55 percent. They will never get to be of any size.

I know probably some Members are concerned that it will be perceived as prorich instead of profamilies and projobs. Representative Cox was telling me that in California, as you may know, they had a referendum someone put on the ballot and repealed their inheritance tax. Massachusetts repealed their death tax 3 years ago because people were moving to Las Vegas, Nevada, and to Florida. They put it on the ballot in California. They voted to repeal the inheritance tax in California. That, to me, is a cross-section of the country. It shows that people really believe you should tax money once and not twice or three times.

Thanks for letting me share my views with you, and I look forward to some questions.

[The prepared statement and attachments follow:]

Statement of Harold I. Apolinsky, Vice President for Legislation, Small Business Council of America; and General Counsel, American Family Business Institute

Mr. Chairman and Members of the Committee, I am Harold I. Apolinsky, General Counsel of the American Family Business Institute and Past Chair of the Small Business Council of America (SBCA) and currently Vice President-Legislation. I am also a practicing tax attorney (over 30 years) who specializes in estate planning and probate. For over 20 years, I have taught estate planning and estate, gift and generation-skipping taxation as my avocation to law school seniors at both the University of Alabama School of Law in Tuscaloosa, Alabama and the Cumberland School of Law in Birmingham, Alabama. I am here to present our views on meaningful estate, gift and generation-skipping relief.

SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, which enterprises represent or sponsor over two hundred thousand qualified retirement and welfare plans, and employ over 1,500,000 employees.

The American Family Business Institute is a recently formed non-profit organization and a successor to the Committee to Preserve the American Family Business. The Committee for a number of years has been working for estate tax relief. Our members are family businesses throughout the United States facing forced sale or liquidation because of the 55% death tax.

Throughout the first two months of the 105th Congress, numerous members have introduced legislation that seeks to address the very serious problems that the federal estate tax laws cause family-owned businesses, farms and capital. Many of the Bills introduced have a significant number of co-sponsors. The legislation drafted by your Committee on Ways and Means will be the most important in securing meaningful estate, gift and generation skipping tax relief.

We are delighted and heartened by the overwhelming response that this issue has evoked from Members of Congress and their staffs. It is indeed refreshing to observe the level of understanding and commitment that individual Members have demonstrated. In the past, the existence and harm of the 55% death tax has not been generally known other than to estate tax lawyers and families who have suffered the loss of a loved one owning more than \$600,000 of assets.

We submit that the time has come for Congress to repeal the estate, gift, and generation-skipping taxes. If this is not possible because of budgetary constraints, then the exemption at which assets are not subject to any estate taxes should be increased dramatically as some bills suggest to \$1 Million to \$2 Million. We also submit that not only should the exemption be increased, but that the tax rates be significantly reduced and the tax brackets expanded.

An estate tax due nine months after death is imposed on the transfer to children or other heirs of the taxable estate of every decedent who is a citizen or resident of the United States (\$600,000 of assets are exempt). The graduated estate tax rates begin effectively at 37% and increase to a maximum rate of 55% (see Exhibit A for how the tax is calculated). Taxes on bequests to spouses may be deferred until the last-to-die of husband and wife.

A gift tax is levied on taxable gifts (excluding \$10,000 per donee per year) as a back-stop to the estate taxes. The graduated rates are the same. (The \$600,000 exempt amount may be used during life for gifts or at death.)

An extra, flat 55% generation-skipping tax is imposed on gifts or bequests to grandchildren (\$1,000,000 is exempt).

Combined income and estate taxes frequently consume 75% or better of retirement plan accounts at death (see chart attached as Exhibit B).

The 1995 White House Conference on Small Business recommended repeal of estate and gift taxes. In fact, ranked by votes, this was the number four (out of sixty) recommendation to come out of the Conference.

President Clinton has expressed the desire to retain and increase jobs. Repeal or a significant cut back and phase out of this deadly tax would accomplish this. AFBI and SBCA contend that any suggestion to solve the problem by simply extending the time period by which payment of the estate taxes is due is no solution at all. If a farm owes \$5,000,000 in estate taxes, does it really matter if the payment of this amount can be spread over a period of time slightly longer than before? We submit that it is not the time period that is critical, it is the exorbitant amount of the tax that is critical.

Only 30% of family business and farms make it through the second generation. Seventy percent (70%) do not. Only 13% make it through the third generation. Eighty-seven (87%) do not. The primary cause of the demise of family businesses and farms, after the death of the founder and the founder's spouse, is the 55% estate tax. It is hard for the successful business to afford enough life insurance. (Premiums are not deductible and deplete working capital.)

A recent study by the research company, Prince and Associates, for National Life of Vermont reviewed the history of 749 family businesses which failed within three years after the death of the founder. The Prince study reinforced and supported the conclusion of the deadly effect of estate taxes. The businesses could not continue as a result of the tax drain on working capital needed to effectively compete and cover errors in judgment made by new and younger management. Jobs were lost in the communities. Key families in the community lost the family business as their base of power and faded away as leaders in that community.

The estate tax took its present form primarily in the early 30's. The express purpose was to break-up wealth. One must question whether this is consistent with a free enterprise economic system and a very competitive world economy? Also, is it consistent at a time when the projected standard of living for our children will be worse than it is for their parents? The estate and gift tax cannot be justified as playing an important role in financing the federal government; it now brings in less than 1.2 percent of total federal revenues. The expense of administering this system probably offset 75% or more of the revenue.

The estate tax system certainly cannot be justified when it is breaking up family farms and family businesses. Years ago, a family working hard on their farms or in their businesses making a modest income would probably not have run into this tax. Now with inflation rich assets, such as that owned by farmers, ranchers, timber companies, even small Mom and Pop stores, it is commonplace for people that few would think of as wealthy to be hit hard by the estate tax. These people who pay a lot of income tax year in and year out, now for the privilege of transferring these assets to their children will be subject to estate tax rates of 37% and higher—as high as 55%. This is a combined tax of over 80%.

If the estate tax were repealed, we believe based upon studies conducted by Professor Richard Wagner of George Mason University, by the Heritage Foundation and by Kennesaw State College (portions of which are attached as Exhibit C) that the beneficial effect on the economy would be significant. According to the study conducted by Professor Richard Wagner of George Mason University, the effect of the estate tax on the cost of capital is so great that within eight years, a U.S. economy without an estate tax would be producing \$80 billion more in annual output and would have created 250,000 additional jobs and a \$640 billion larger capital stock.

The Heritage Foundation study utilizing two leading econometric models also found that repealing the estate tax would have a beneficial effect on the economy. The Heritage analysis found that if the tax were repealed in 1996, over the next nine years: The nation's economy would average as much as \$11 billion per year in extra output; An average of 145,000 additional new jobs could be created; Personal income could rise by an average of \$8 billion per year above current projections; and The deficit actually would decline, since revenues generated by extra growth would more than compensate for the meager revenues currently raised by the inefficient estate tax.

We submit if repealing estate taxes accomplished only half of these things, even a third or a fourth of them, then the country would be significantly better off than staying under the current draconian estate tax system. The estate tax system raises very little revenue at a heavy cost to the economy. It generates complex tax avoidance schemes, it promotes spending instead of saving and it promotes people giving up on the family business or farm.

The hardest hit by the tax are small business people who work hard to pass on their farm or business to their children. To this end, a complex family business carve out has been introduced into legislation, S. 2. It is similar to the 2033A which was in the Balance Budget Tax Act of 1995. The problem is that this carve-out is much too complicated. Optimistic estimates are that it will not help more than 10% of the family businesses or farms hurt by estate taxes and will not save many of the jobs lost when a company dies. There are several hoops a business or farm must jump through before this carve out can help it. First, the business must comprise at least 50% of the estate. Sometimes this is the case, but often it is not. Second, the decedent must have materially participated in the business for a specified number of years prior to death. Just think of the litigation resulting from the words, materially participated.... Third, the business must be left to one or more qualified heirs, these are designated family members and long time employees *and* those people must continue to actively participate in the business for at least ten years after receiving the stock from the decedent. Again, imagine the litigation resulting from the words—active participation Surely, there must be a better way to protect our country's family farms and businesses.

Overall, a carve-out will have very limited application but will definitely create the need for spending many more dollars on estate tax attorneys and accountants. Small businesses have already spent more than enough on this problem. They need their working capital to keep their businesses viable and to continue to provide jobs.

The tax services list 133 cases where the IRS has denied relief under the last carve-out for family farms—2032A (which has not worked to save these farms). The new suggested provision 2033A incorporating 12 provisions of 2032A will send my grandchildren through professional school. I am grateful but urge that funds available be spent toward a total phase out of the death tax over time, not to a gift to tax lawyers and accountants. A more extended study of 2033A is attached as Exhibit D.

The Kennesaw State College Study on the Impact of the Federal Estate Tax, prepared by Astrachan and Aronoff, studied in detail the impact of the estate tax on members of the Associated Equipment Distributors (AED), an association composed of capital-intensive family-owned distribution businesses and on newly-emerging, minority-owned family enterprises selected from lists published by Black Enterprise Magazine. The study showed that for the AED group:

- Nearly \$5 million is spent annually in life insurance premiums in order to have proceeds available to meet their estate tax liability. The survey shows an average of \$27,000 per year expended by distributors on such insurance.

- \$6.6 million has been spent on lawyers, accountants and other advisors for estate tax planning purposes. On average companies spent nearly:

- \$20,000 in legal fees
- \$11,900 in accounting fees
- \$11,200 for other advisors

- In addition to the protection provided by life insurance premiums, roughly 12% of the AED respondents reserved over \$51 million in liquid assets for the purpose of having cash available for the payment of the estate tax.

I do not think we need to be an expert in anything to realize this is an awful lot of money not being spent in a particularly useful fashion when viewed through the eyes of our society. Probably worse, this same study found that 71% of the AED respondents would not have taken the actions they did *but for* the estate tax—in other words, actions were being taken that served no business purpose, they only served to alleviate the draconian effect of the estate tax. 46% of this group restructured the ownership of the company because of estate tax considerations (this statistic could be read to mean that 46% of them had restructured themselves right out of the so-called family business carve out which is one more problem with that solution). 11% have actually slowed down the business to limit estate tax burdens. Worse, the study showed that 57% of the businesses felt that the imposition of the estate tax would make long term survival of the business after the death of the current owner significantly more difficult and 9% thought it would make it impossible. They are not wrong—the statistics show it is extraordinarily difficult to have the family business survive the death of the first generation.

Congress should repeal the estate tax in 1997. It will greatly assist family capital and family businesses of all kinds. If dollar constraints and the need to balance the budget limit what Congress can do at this point, then increasing the tax free amount (the exemption amount), while bringing the rates down and expanding the brackets is the best solution. For instance, the estate tax system could call for a 15% tax rate on all estates between the exemption level and ten million and then impose a 20% rate on all estates between 10 and 20 million and have a tax rate of 30% on all estates over that amount. We submit this kind of change will save the family farms and businesses and keep the jobs that all of these businesses provide. It will also prevent massive wealth from being transferred without any taxation at all. It should also bring the capital gains and estate tax system into a neutral stance so that desired actions are not postponed until death.

The transfer tax provisions represent 82 pages of the Internal Revenue Code and 289 pages of Regulations issued by the Internal Revenue. The transfer tax system forces many estates, the Internal Revenue Service, and the Department of Justice to expend funds in court. The number of transfer tax cases now total 10,247 representing some 13,050 pages of the Commerce Clearing House Tax Publication.

Australia repealed their estate and gift tax laws in the mid-1970's. It was felt that these transfer taxes were an inhibitor on the growth of family businesses. The legislative body of Australia sought more jobs which they believed would come if family businesses grew larger and were not caused to sell, downsize, or liquidate at the death of the founder to pay estate taxes. More recently, Canada has also repealed estate taxes for the same reasons.

The SBCA has a legal and advisory board comprised of the top legal, accounting, insurance, pension and actuarial advisors to small business in the country. It is contrary to the financial interests of these board members in their tax practice and advisory businesses to urge repeal of these transfer taxes. We stand firmly behind repeal or significant reform, however, because it is the right thing to do to help grow family businesses, provide jobs and encourage the entrepreneurial spirit needed for small businesses to become large businesses.

We applaud the bills introduced by Congressman Cox (HR 902) AND Senators Kyl (S-75) and Lugar (S-30) to repeal these taxes. The country will be far better off if any of them become law. As a country, we cannot stand by and see one more farm or one more small business get torn apart because of an obsolete tax supposedly in place to redistribute massive wealth. Part of the problem with estate taxes is that many of the families who are ultimately destroyed by the estate tax are not even

aware that it exists. Many times no one in the family has ever been subjected to it.

The 55% death tax (the highest in the world) does the most harm to capital of any tax we have. Once it leaves the family at death and goes to Washington, it never seems to come back to provide jobs back home.

Exhibit A, Calculation of Estate Taxes

Gross Estate (fair market value at death of all assets, including real estate, stock, cash, life insurance, retirement accounts, etc.).

Deductions:

1. Debts and expenses.
 2. Marital (assets left to spouse if citizen).
 3. Charitable.
- C. Taxable Estate.
D. Add Prior Taxable Gifts.
E. Total transfer to heirs (life and death).
F. Apply Rates: 18% to 55%.
G. Less credit (\$192,800*)

H. Net tax (effective 37% to 55% [plus 5% for larger estates] due 9 months after death.

- I. Extra 55% tax for bequests to grandchildren in excess of \$1 million.

*This is tax on \$600,000 taxable estate.

The complexity for filing the estate tax return is demonstrated by the 35 hours and 83 minutes estimated pursuant to the Paperwork Reduction Act Notice.

Exhibit D, American Family Business Institute, Small Business Council of America

CONCERNS WITH EXISTING CODE SECTION 2032A AND ANY BUSINESS CARVE OUT BASED THEREON

The family-owned business provisions of S.2 (i.e., the proposed Section 2033A) mirror the statutory scheme that currently exists in Section 2032A of the tax code. In fact, the proposal repeatedly refers to various subsections of the existing provision to resolve various details relating to definitions, the treatment of different types of taxpayers, etc.

The technical experts and practitioners that AFBI met with expressed serious reservations about basing estate tax reform on the existing Section 2032A. It is believed that the Section is much too complex and restrictive to ever be of significant benefit to the family farms that it originally was designed to help. Its applicability also has proven to be subject to relentless attacks from the Internal Revenue Service. Commerce Clearing House tax publications describe Section 2032A as follows:

Code Sec. 2032A is a very technically complex statute that is generally interpreted with nit-picking narrowness by the IRS. The possible exposure to malpractice liability for failure to perfect a Code Sec. 2032A election or the giving of incorrect advice regarding recapture tax is a serious concern.

The same publishers have described the IRS' unrelenting attacks on Section 2032A as follows:

Congress has expressed concern that the IRS is interpreting 2032A in a more restrictive manner than contemplated by Congress. See *Estate of Davis v. Commissioner* [Dec. 43, 105], 86 T.C. 1156, 1164 (1986). United States Senator Alan J. Dixon of Illinois noted the tension between Congress' purpose in enacting 2032A and the IRS' administrative policy under that section in a Senator floor amendment in which he proposed the perfection provision contained in Code 2032A(d)(3).

Congress wants to continue the family farm and small family-owned enterprises. Congress does not want the death of one owner of a family farm or a small family-operated business to force the sale of that farm or business if the family wants to stay in farming or the small business. The idea was to not permit the federal estate tax to destroy the farms or small businesses.

There seems to be people at the IRS, however, who are not interested in preserving the family farms and small business, and who want to use the slightest tech-

nically to prevent an estate from being valued under the provisions of Section 2032A.

The practitioners summarized their principal concerns about using the existing Section 2032A as the basis for estate tax reform as follows:

1. Benefits may be outweighed by heavy costs. Because of the unusual complexity in Section 2032A, family-owned businesses could incur substantial additional legal and accounting costs (easily an average increase of \$15,000 in professional fees for each such business) for every estate plan for or to determine applicability of the proposed Section 2033A.

2. Constant litigation could result. Section 2032A (from which Section 2033A has been cloned), though rarely elected, has been the subject of more than 130 litigated cases between taxpayers undertaking to elect the intended benefits of the section and the Internal Revenue Service which, contrary to the remedial nature of the statute, is continuously and successfully undertaking to limit its applicability and restrict its remedial benefits. A listing of the cases is attached as Exhibit 1. There may be an equal number not yet concluded and reported.

3. Family planning could be more difficult and costly. Not only could estates attempting to utilize Section 2033A become involved with costly disputes with the IRS, heirs could likewise become entangled in various personal traps and disputes. For example,

a. If the value of business interests declined during the ten-year estate tax recapture period, heirs could owe more in recaptured estate taxes than the gross proceeds realized upon disposition of such business interests.

b. Heirs could unwittingly bear disproportionately large percentages of the overall estate tax in situations in which all heirs bore the initial tax on non-excluded estate assets proportionately, but qualified heirs who received excluded business interests would alone share the entire burden of an recapture tax.

4. Qualification is unduly complex and uncertain. The qualification computation itself is unreasonably complex and cumbersome, requiring at least five obscure variables in the numerator (e.g., liquid assets in excess of reasonably expected day-to-day working capital needs) and at least six obscure variables in the denominator of a fraction which must exceed 50% of the A.G.E., so that the miscalculation of one of such eleven factors could have devastatingly adverse consequences of the estate. See Exhibit 2, attached.

5. Benefits could be too limited. In 1995, the proposed Section 2033A was severely restricted by Congress as it worked its way through the legislative process. The benefits were reduced so much in 1995 (valuation reductions were limited to a maximum of \$1,750,000) that the planning costs, complexities, uncertainties, and continuous predictable attacks from the IRS were far too great to justify such a limited benefit.

6. Non-elective mandate forces unwilling participation and costs. Proposed section 2033A's application is mandated, and is not, like even section 2032A, elective. As written, compliance costs and fees can easily exceed any benefit from section 2033A, yet businesses would be forced even against their will to deal with the statute's complexities and bear such added out-of-pocket expenses.

7. Planning is uncertain and inflexible. Unlike most family farms, business interests are more likely to be the subject of complex transactions such as incorporations, mergers and other forms of reorganizations and recapitalizations effecting subtle shifts in financial interests, etc. The ramifications of these complex transactions would be difficult to deal with under section 2033A.

PROPOSED CHANGES TO SECTION 2033A

As noted above, we asked the group of practitioners and tax experts what changes would be required to simplify the proposed Section 2033A to make it at least arguably workable in the field. Numerous suggestions were made, but it was agreed that at least the following would be required to correct the legislative text:

1. Expand definition of trade or business. Whether or not an activity and related estate assets constitute a trade or business is necessarily a question of fact and could be a source of constant litigation. For example, based on IRS interpretation of Section 2033A, tree farming encompassing the planting, ownership and maintenance of forest lands in anticipation of future harvesting would not constitute a trade or business whereas professional gambling would be a trade or business. In order to qualify their forestry activities for traded or business purposes, tree farmers would be required to initiate timber cutting activities, even if such cutting was premature and ill-advised for both business and environmental purposes. Similar problems exist for other nature resource-based businesses, and businesses developing, owning and managing intangibles and other tangible property. The proposed statute

must greatly expand the traditional definition of a trade or business to specifically incorporate such activities by utilizing a more relaxed active asset management test. We recognize that administrators have legitimate concerns regarding an overly broad definition, but the current approach is unworkable.

2. Exclude Recapture on Ordinary Asset Sales. Sale of business assets, including inventory, plant and equipment, timber, crops, minerals, etc. in the ordinary course of a trade or business during the recapture period must not trigger recapture of estate tax. Recapture under such circumstances eliminates intended benefits, and would cause continuous filings and massive professional fees clearly providing a net negative impact on the small business.

3. Eliminate Material Participation. The material participation requirement should be eliminated. Businesses, even more so than family farms, need competent professional management. It should be contrary to public policy to impose tax penalties for replacing aged, inform or incompetent family management with competent, professional non-family managers if necessary to maintain the economic health and viability of the business. So long as the family continues to own, operate and invest in the business, society continues to benefit from the stability and commitment inherent in such ownership.

4. Expand the Definition of Family. After the second generation, it would be difficult for any family to qualify for the heirship or for material participation purposes as family is currently defined. Expand the definition of family by at least adopting the 447(e)(1) definition.

5. A qualified heir should be permitted to receive his or her interest through a trust.

6. Eliminate 50% of A.G.E. Test. There are numerous complexities and unfair results arising from this very high-percentage cliff approach. It's easy to see the unfairness that would result comparing the family that owns 49% with the family that owns 51% particularly when valuation of such qualifying interests is so subjective and the source of continuous litigation. The cliff approach assures constant litigation with the IRS. There is also concern that a business suddenly may be worth much less due to the loss of its driving force, while the values of the non-business assets may be unaffected by the death.

7. If any A.G.E. cliff test remains, a number of experts suggested that it be changed from a 50% to a 10% test.

8. If any A.G.E. test remains the value of the principle residence should be eliminated from the computation of the adjusted gross estate. For small businesses, the value of the residence could be a significant factor in determining eligibility under any percentage of adjusted gross estate test.

9. If any A.G.E. test remains, then language should be provided to ensure that the creation of ESOPs for gifts of qualifying business interests or gifts to charity do not prevent families from availing themselves of the provisions of this legislation. There are two sections where you might consider taking transfers to ESOPs and charities into consideration. First, is the section relating to eligibility for the exclusion, i.e., the 50%-of-adjusted-gross-estate test. Language should be added to apply any such test only to that portion of the ownership interests not held by a qualified ESOP or charity. Second, in the section dealing with disqualifying dispositions, transfer of ownership interests to a qualified ESOP or charity should not trigger the recapture provisions.

10. If any A.G.E. test remains, include the gifts of the spouse in determining the adjusted taxable gift component in the 50%-of-adjusted-gross-estate test. Many married couples make separate, lifetime gifts of business interests (or they utilize the gift-splitting provisions under which they are deemed to have made separate gifts). If only the decedent's gifts of family business interests are counted in determining adjusted taxable gifts, many family businesses will fail to qualify under section 2033A simply because of the form chosen for lifetime gifting.

11. If any A.G.E. test remains, then modify the calculation of the adjusted-gross-estate test to ensure that the determination of the denominator does not count certain assets twice. An example helps demonstrate how this could happen: Assume the spouse receiving the gifted assets (donee) is the first to die and all of the assets are placed into a QTIP trust for the benefit of the surviving donor spouse to take advantage of the marital deduction. Upon the death of the second spouse, the assets of that spouse plus the QTIP assets will be included in the estate tax return of the second spouse. Apparently, in determining the adjusted gross estate under Section 2033A, the previously gifted assets themselves must again be included in the calculation, even though the value of the assets themselves already is included in the gross estate of the second spouse by way of inclusion of the QTIP assets. At a minimum, this provision should be modified to somehow exclude those assets that were gifted and subsequently added back to the estate of the donor because of the work-

ings of the marital deduction. An even better result would be to eliminate the spousal gift portion of the calculation altogether.

12. If any A.G.E. test remains, then clarify that various family-owned business interests may be aggregated for purposes of meeting the percentage of adjusted-gross-estate test. It is common for various components of family-owned businesses to be held in different forms of entities (including entities that are unrelated). Any one of the companies may not constitute the necessary percentage of the adjusted gross estate. Provisions similar to those in Code Section 6166(c) would have to be considered.

13. Redraft restrictions on working capital. The current language will produce litigation and unfairness. The tree farming business provides a useful illustration. The expansion of one's timber holdings requires significant amounts of cash and companies and requires many years to accumulate sufficient funds to effect their next purchase (the unanticipated withdrawal of federal timberlands from the Northwest timber base has created a need for companies to more aggressively acquire private lands to insure adequate timber supply). Any impartial observer, probably even the IRS, would agree that cash being accumulated for such appropriate business purposes was acceptable. But such accumulations would not necessarily meet the day-to-day test in the bill. Some commenters suggested flat percentage tests, but that would allow for no flexibility to reflect the very different capital needs of differing businesses. It appears that "reasonable business needs" test would provide more flexibility, but would still be a source of continuing uncertainty and litigation.

14. Integrate the proposed Section 2033A general exclusion with the generation-skipping transfer tax.

15. Integrate the proposed Section 2033A general exclusion with the gift tax credit provisions. One can envision a situation where a gift tax has been paid in certain years on amounts that (although above the annual gift tax exclusion) would not have been subject to tax had the assets been retained in the estate. The estate should get credit for the gift taxes already paid (or a refund if they exceed the estate tax owed). In the absence of this clarification, passage of proposed Section 2033A would create an incentive not to begin the transfer of the business to the next generation during the life of the deceased. That would seem to defeat our desire to facilitate the smooth transfer of family business ownership to the next generation.

16. Redraft sections to clarify which persons are responsible for payment of any recapture tax. Under the current draft language, the experts envision planning costs and difficulties as well as family disputes over efforts to fairly distribute the overall estate tax burden where qualifying business interests do not pass proportionately to all family members. At this point, it remains unclear how best to redraft this section.

17. Minimize the family-owned tests. Reducing ownership percentages to as little as 10% would still limit applicability to only intended circumstances. Utilizing ownership tests involving ownership by other families can create severe complications for planning purposes.

18. Ease strict prohibition on public ownership of securities. Growing family businesses should not be penalized for seeking essential capital in public financial markets. Public ownership of 30% of a company's stock in no way removes the liquidity needs or provides a reasonable market for 70% of the business still held by the family.

PREFERRED ALTERNATIVES

As discussed above, there are significant problems with the current draft of Section 2033A. Significant changes would have to be made to make it workable for the estate planning professionals in the field. Rather than spend time and effort to fix or draft something which will not help a significant number of family businesses and farms (but will enrich tax lawyers and accountants) we suggest:

1. Increase the unified credit (tax free amount) significantly. Consider a phase in (as occurred in 1982 Tax Act—ERTA) to \$5,000,000.

2. A phased reduction in the Estate Tax Rates. Target zero as soon as affordable.

3. Expansion of the Existing Rate Brackets. Broaden the brackets so that the highest rates would not kick in as soon.

Exhibit 1

1. C.I.R. v. McCoy, 484 U.S. 3, 108 S.Ct. 217, 98 L.Ed.2d 2, 60 A.F.T.R.2d 87-6150, 87-2 USTC P 13,736 (U.S., Oct 19, 1987) (NO. 87-75)
2. Ernzen v. Ernzen, 105 F.3d 669 (Table, Text in WESTLAW), Unpublished Disposition, 1997 WL 7276, 97 CJ C.A.R. 115 (10th Cir.(Kan.), Jan 09, 1997) (NO. 95-3145)
3. LeFever v. C.I.R., 100 F.3d 778, 78 A.F.T.R.2d 96-7335 (10th Cir., Nov 13, 1996) (NO. 95-9022)
4. In re Estate of Lucas, 97 F.3d 1401, 78 A.F.T.R.2d 96-6911 (11th Cir.(Fla.), Oct 23, 1996) (NO. 95-2370)
5. Estate of Hoover v. C.I.R., 69 F.3d 1044, 76 A.F.T.R.2d 95-7305, 95-2 USTC P 60,217 (10th Cir., Nov 01, 1995) (NO. 94-9018)
6. Estate of Hudgins v. C.I.R., 57 F.3d 1393, 64 USLW 2044, 76 A.F.T.R.2d 95-5401, 95-2 USTC P 60,202 (5th Cir., Jun 28, 1995) (NO. 94-40211)
7. Estate of Klosterman v. C.I.R., 32 F.3d 402, 74 A.F.T.R.2d 94-5193, 74 A.F.T.R.2d 94-7453, 94-2 USTC P 60,172 (9th Cir., Jul 05, 1994) (NO. 93-70349)
8. Minter v. U.S., 19 F.3d 426, 73 A.F.T.R.2d 94-1721, 73 A.F.T.R.2d 94-2365, 94-1 USTC P 60,160 (8th Cir.(N.D.), Mar 23, 1994) (NO. 92-3745ND)
9. Estate of Doherty v. C.I.R., 982 F.2d 450, 61 USLW 2429, 71 A.F.T.R.2d 93-2155, 93-1 USTC P 60,125 (10th Cir., Dec 31, 1992) (NO. 919013)
10. Poisl v. C.I.R., 978 F.2d 1261 (Table, Text in WESTLAW), Unpublished Disposition, 1992 WL 321001 (7th Cir., Nov 04, 1992) (NO. 92-1080)
11. Williamson v. C.I.R., 974 F.2d 1525, 61 USLW 2201, 70 A.F.T.R.2d 92-6244, 92-2 USTC P 60,115 (9th Cir., Sep 14, 1992) (NO. 89-70506)
12. McAlpine v. C.I.R., 968 F.2d 459, 70 A.F.T.R.2d 92-6216, 92-2 USTC P 60,109 (5th Cir., Aug 04, 1992) (NO. 91-4699)
13. Estate of Wallace v. C.I.R., 965 F.2d 1038, 70 A.F.T.R.2d 92-5349, 92-2 USTC P 50,387 (11th Cir., Jul 13, 1992) (NO. 91-7318)
14. Bartlett v. C.I.R., 937 F.2d 316, 68 A.F.T.R.2d 91-6015, 91-2 USTC P 60,078 (7th Cir., Jul 12, 1991) (NO. 89-2237)
15. Estate of Wood v. C.I.R., 909 F.2d 1155, 59 USLW 2097, 66 A.F.T.R.2d 90-5987, 90-2 USTC P 50,488, 90-2 USTC P 60,031 (8th Cir., Jul 26, 1990) (NO. 89-2366)
16. Brockman v. C.I.R., 903 F.2d 518, 65 A.F.T.R.2d 90-1249, 90-1 USTC P 60,026 (7th Cir., Jun 05, 1990) (NO. 89-1559)
17. Prussner v. U.S., 896 F.2d 218, 65 A.F.T.R.2d 90-1222, 90-1 USTC P 60,007 (7th Cir.(Ill.), Feb 15, 1990) (NO. 88-1933)
18. Smoot v. U.S., 892 F.2d 597, 58 USLW 2401, 65 A.F.T.R.2d 90-1177, 90-1 USTC P 60,002 (7th Cir.(Ill.), Dec 27, 1989) (NO. 88-2058)
19. Heffley v. C.I.R., 884 F.2d 279, 64 A.F.T.R.2d 89-5909, 89-2 USTC P 13,812 (7th Cir., Aug 17, 1989) (NO. 88-1929)
20. Foss v. U.S., 865 F.2d 178, 63 A.F.T.R.2d 89-1524, 89-1 USTC P 13,793 (8th Cir.(Minn.), Jan 09, 1989) (NO. 88-5152)
21. Estate of Thompson v. C.I.R., 864 F.2d 1128, 63 A.F.T.R.2d 89-1515, 89-1 USTC P 13,792 (4th Cir., Jan 03, 1989) (NO. 88-3981)
22. McDonald v. C.I.R., 853 F.2d 1494, 62 A.F.T.R.2d 88-5995, 88-2 USTC P 13,778 (8th Cir., Aug 17, 1988) (NO. 87-2389)
23. Mangels v. U.S., 828 F.2d 1324, 60 A.F.T.R.2d 87-6145, 87-2 USTC P 13,734 (8th Cir.(Iowa), Sep 16, 1987) (NO. 86-1647)
24. Whalen v. U.S., 826 F.2d 668, 60 A.F.T.R.2d 87-6127, 87-2 USTC P 13,729 (7th Cir.(Ill.), Aug 13, 1987) (NO. 86-2997)
25. Estate of McCoy v. C.I.R., 809 F.2d 87-1207, 87-1 USTC P 13,707 (6th Cir., Jan 23, 1987) (NO. 86-1008)
26. Schuneman v. U.S., 783 F.2d 694, 54 USLW 2439, 89 A.L.R. Fed. 85, 57 A.F.T.R.2d 86-1530, 86-1 USTC P 13,660 (7th Cir.(Ill.), Feb 10, 1986) (NO. 84-2651, 84-2888)
27. Martin v. C.I.R., 783 F.2d 81, 54 USLW 2440, 57 A.F.T.R.2d 86-1527, 86-1 USTC P 13,659 (7th Cir.(Ind.), Feb 03, 1986) (NO. 85-2077, 85-2088)
28. Estate of Sherrod v. C.I.R., 774 F.2d 1057, 56 A.F.T.R.2d 85-6594, 85-2 USTC P 13,644 (11th Cir., Oct 25, 1985) (NO. 84-7682)
29. Estate of Cowser v. C.I.R., 736 F.2d 1168, 84-2 USTC P 13,579 (7th Cir., Jun 13, 1984) (NO. 83-2329)
30. Rath v. U.S., 733 F.2d 594, 84-1 USTC P 13,573 (8th Cir.(Neb.), May 09, 1984) (NO. 83-2552)
31. Ernzen v. Ernzen, 1995 WL 261131 (D.Kan., Apr 03, 1995) (NO. CIV. A. 94-2265-EEO)
32. Ernzen v. Ernzen, 878 F.Supp. 190 (D.Kan., Feb 28, 1995) (NO. CIV. A. 94-2265-EEO)
33. Gettysburg Nat. Bank v. U.S., 806 F.Supp. 511, 72 A.F.T.R.2d 93-6769 (M.D.Pa., Nov 19, 1992) (NO. CIV.A.1:CV-90-1607)
34. Simpson v. U.S., 1992 WL 472023, 92-2 USTC P 60,118 (D.N.M., Aug 31, 1992) (NO. CIV-90-827 SC)
35. Gettysburg Nat. Bank v. U.S., 1992 WL 472022, 70 A.F.T.R.2d 92-6229, 92-2 USTC P 60,108 (M.D.Pa., Jul 17, 1992) (NO. 1:CV-90-1607)
36. Parker v. U.S., 1991 WL 338264, 68 A.F.T.R.2d 91-6056, 91-2 USTC P 60,082 (E.D.Ark., Jul 31, 1991) (NO. CIV. J-C-89-91)
37. Collins v. U.S., 1991 WL 496861, 91-1 USTC P 60,060 (W.D.Okla., Jan 31, 1991) (NO. CIV-90-324-P)
38. Parker v. U.S., 1990 WL 300672, 90-2 USTC P 60,038 (E.D.Ark., Aug 17, 1990) (NO. J-89-91)
39. Parker v. U.S., 1990 WL 300673, 90-2 USTC P 60,028 (E.D.Ark., May 30, 1990) (NO. J-89-91)

40. Miller v. U.S., 680 F.Supp. 1269, 61 A.F.T.R.2d 88-1370, 88-1 USTC P 13,757 (C.D.Ill., Mar 09, 1988) (NO. 86-3245)
41. Foss v. U.S., 1987 WL 49368, 63 A.F.T.R.2d 89-1503, 88-1 USTC P 13,762 (D.Minn., Dec 21, 1987) (NO. 6-86-711)
42. Voorhis v. U.S., 1987 WL 49370, 88-1 USTC P 13,749 (C.D.Ill., Nov 20, 1987) (NO. 86-3150)
43. Smoot v. C.I.R., 1987 WL 49387, 63 A.F.T.R.2d 89-1533, TC P 13,748 (C.D.Ill., Nov 16, 1987) (NO. 85-2431)
44. Prussner v. U.S., 1987 WL 47915, 87-2 USTC P 13,739 (C.D.Ill., Oct 13, 1987) (NO. 85-2442)
45. Bruch v. U.S., 1986 WL 83454, 58 A.F.T.R.2d 86-6383, 86-2 USTC P 13,692 (N.D.Ind., Sep 03, 1986) (NO. CIV. A. F 83-410)
46. Mangels v. U.S., 632 F.Supp. 1555, 58 A.F.T.R.2d 86-6361, 86-2 USTC P 13,682 (S.D.Iowa, Apr 22, 1986) (NO. CIV. 84-10-D-2)
47. Whalen v. U.S., 1985 WL 6355, 86-1 USTC P 13,661 (C.D.Ill., Nov 14, 1985) (NO. 84-3020)
48. Bixler v. U.S., 616 F.Supp. 177, 56 A.F.T.R.2d 85-6532, 85-2 USTC P 13,623 (D.S.D., May 31, 1985) (NO. CIV. 84-1059)
49. Schuneman v. U.S., 1984 WL 2810, 57 A.F.T.R.2d 86-1545, 84-1 USTC P 13,561 (C.D.Ill., Jan 31, 1984) (NO. 82-4027)
50. Schuneman v. U.S., 570 F.Supp. 1327, 83-2 USTC P 13,540 (C.D.Ill., Sep 14, 1983) (NO. 82-4027)
51. Teubert v. U.S.A., 1983 WL 1615, 83-1 USTC P 13,513 (D.Minn., Jan 31, 1983) (NO. 3-82-43)
52. In re Morgan, 1990 WL 208790 (Bankr.E.D.Okla., Jan 22, 1990) (NO. 89-70816)
53. Matter of Moellenbeck, 83 B.R. 630, Bankr. L. Rep P 72,144 (Bankr.S.D.Iowa, Mar 01, 1988) (NO. 87-1258-D)
54. Matter of C.R. Druse, Sr., Ltd., 82 B.R. 1013 (Bankr.D.Neb., Feb 05, 1988) (NO. BK87-346)
55. Estate of Trueman v. U.S., 6 Cl.Ct. 380, 54 A.F.T.R.2d 84-6514, 84-2 USTC P 13,590 (Cl.Ct., Oct 04, 1984) (NO. 309-82T)
56. Carmean v. U.S., 4 Cl.Ct. 181, 84-1 USTC P 13,551 (Cl.Ct., Dec 23, 1983) (NO. 328-82T)
57. Hohenstein v. C.I.R., T.C. Memo. 1997-56, 1997 WL 34996, 73 T.C.M. (CCH) 1886, T.C.M. (RIA) 97,056 (U.S. Tax Ct., Jan 30, 1997) (NO. 22282-94)
58. Estate of Neumann v. C.I.R., 106 T.C. No. 10, 106 T.C. 216, Tax Ct. Rep. (CCH) 51,280, Tax Ct. Rep. Dec. (P-H) 106.10 (U.S. Tax Ct., Apr 09, 1996) (NO. 11060-94)
59. Estate of Kokernot v. C.I.R., T.C. Memo. 1995-590, 1995 WL 735295.M. (CCH) 1559, T.C.M. (P-H) 95,590 (U.S. Tax Ct., Dec 13, 1995) (NO. 16088-94)
60. Ripley v. C.I.R., 105 T.C. No. 23, 105 T.C. 358, Tax Ct. Rep. (CCH) 50,986, Tax Ct. Rep. Dec. (P-H) 105.23 (U.S. Tax Ct., Nov 08, 1995) (NO. 26209-93)
61. Estate of Sequeira v. C.I.R., T.C. Memo. 1995-450, 1995 WL 558728, 70 T.C.M. (CCH) 761, T.C.M. (P-H) 95,450 (U.S. Tax Ct., Sep 21, 1995) (NO. 16264-91)
62. LeFever v. C.I.R., T.C. Memo. 1995-321, 1995 WL 422679, 70 T.C.M. (CCH) 98, T.C.M. (P-H) 95,321 (U.S. Tax Ct., Jul 19, 1995) (NO. 19915-92)
63. Estate of Monroe v. C.I.R., 104 T.C. No. 16, 104 T.C. 352, Tax Ct. Rep. (CCH) 50,539, Tax Ct. Rep. Dec. (P-H) 104.16 (U.S. Tax Ct., Mar 27, 1995) (NO. 9819-93)
64. Tate; Lyle, Inc. v. C.I.R., 103 T.C. 656, Tax Ct. Rep. (CCH) 50,241, Tax Ct. Rep. Dec. (P-H) 103.37 (U.S. Tax Ct., Nov 15, 1994) (NO. 740-92)
65. LeFever v. C.I.R., 103 T.C. No. 31, 103 T.C. 525, Tax Ct. Rep. (CCH) 50,206, Tax Ct. Rep. Dec. (P-H) 103.31 (U.S. Tax Ct., Oct 26, 1994) (NO. 19915-92)
66. Estate of Hoover v. C.I.R., 102 T.C. No. 36, 102 T.C. 777, Tax Ct. Rep. (CCH) 49,919, Tax Ct. Rep. Dec. (P-H) 102.36 (U.S. Tax Ct., Jun 21, 1994) (NO. 18464-92)
67. Estate of Einsiedler v. C.I.R., T.C. Memo. 1994-155, 1994 WL 125924, 67 T.C.M. (CCH) 2647, T.C.M. (P-H) 94,155 (U.S. Tax Ct., Apr 13, 1994) (NO. 4461-91)
68. Estate of Climer v. C.I.R., T.C. Memo. 1994-29, 1994 WL 17919, 67 T.C.M. (CCH) 2017, T.C.M. (P-H) 94,029 (U.S. Tax Ct., Jan 24, 1994) (NO. 21678-91)
69. Stovall v. C.I.R., 101 T.C. No. 9, 101 T.C. 140, Tax Ct. Rep. (CCH) 49,183, Tax Ct. Rep. Dec. (P-H) 1019 (U.S. Tax Ct., Jul 29, 1993) (NO. 19432-91, 19434-91, 19436-91, 19438-91, 19433-91, 19437-91, 19435-91)
70. Rockwell Inn, Ltd. v. C.I.R., T.C. Memo. 1993-158, 1993 WL 112452, 65 T.C.M. (CCH) 2374, T.C.M. (P-H) 93,158 (U.S. Tax Ct., Apr 13, 1993) (NO. 21842-91)
71. Fisher v. C.I.R., T.C. Memo. 1993-139, 1993 WL 9 T.C.M. (CCH) 2284, T.C.M. (P-H) 93,139 (U.S. Tax Ct., Apr 05, 1993) (NO. 9383-90, 9416-90, 9417-90)
72. Estate of Mapes v. C.I.R., 99 T.C. No. 27, 99 T.C. 511, Tax Ct. Rep. (CCH) 48,609, Tax Ct. Rep. Dec. (P-H) 99.7 (U.S. Tax Ct., Oct 29, 1992) (NO. 1038-89)
73. Estate of Dooley v. C.I.R., T.C. Memo. 1992-557, 1992 WL 231695, 64 T.C.M. (CCH) 824, T.C.M. (P-H) 92,557 (U.S. Tax Ct., Sep 22, 1992) (NO. 11131-88, 23026-88, 23027-88)
74. Estate of Klosterman v. C. I. R., 99 T.C. No. 16, 99 T.C. 313, Tax Ct. Rep. (CCH) 48,496, Tax Ct. Rep. Dec. (P-H) 99.16 (U.S. Tax Ct., Sep 10, 1992) (NO. 27652-89)
75. Ann Jackson Family Foundation v. C. I. R., 97 T.C. No. 35, 97 T.C. 534, Tax Ct. Rep. (CCH) 47,736, Tax Ct. Rep. Dec. (P-H) 97.35 (U.S. Tax Ct., Nov 12, 1991) (NO. 28883-89)
76. Estate of Holmes v. C. I. R., T.C. Memo. 1991-477, 1991 WL 188869, 62 T.C.M. (CCH) 839, T.C.M. (P-H) 91,477 (U.S. Tax Ct., Sep 26, 1991) (NO. 27129-89)
77. Shaw v. C. I. R., T.C. Memo. 1991-372, 1991 WL 148902, 62 T.C.M. (CCH) 396, T.C.M. (P-H) 91,372 (U.S. Tax Ct., Aug 08, 1991) (NO. 5219-89)
78. Estate of Hughan v. C. I. R., T.C. Memo. 1991-275, 1991 WL 102698, 61 T.C.M. (CCH) 2932, T.C.M. (P-H) 91,275 (U.S. Tax Ct., Jun 17, 1991) (NO. 23221-88)

79. Estate of McAlpine v. C. I. R., 96 T.C. No. 6, 96 T.C. 134, Tax Ct. Rep. (CCH) 3963, Tax Ct. Rep. Dec. (P-H) 96.6 (U.S. Tax Ct., Jan 24, 1991) (NO. 28298-87)
80. Estate of Wallace v. C. I. R., 95 T.C. No. 37, 95 T.C. 525, Tax Ct. Rep. (CCH) 46,977, Tax Ct. Rep. Dec. (P-H) 95.37 (U.S. Tax Ct., Nov 14, 1990) (NO. 22960-88)
81. Estate of Doherty v. C. I. R., 95 T.C. No. 32, 95 T.C. 446, Tax Ct. Rep. (CCH) 46,929, Tax Ct. Rep. Dec. (P-H) 95.32 (U.S. Tax Ct., Oct 18, 1990) (NO. 5568-88)
82. Estate of Merwin v. C. I. R., 95 T.C. No. 13, 95 T.C. 168, Tax Ct. Rep. (CCH) 46,817, Tax Ct. Rep. Dec. (P-H) 95.13 (U.S. Tax Ct., Aug 21, 1990) (NO. 23398-88)
83. Estate of Pattison v. C. I. R., T.C. Memo. 1990-428, 1990 WL 112409, 60 T.C.M. (CCH) 471, T.C.M. (P-H) 90,428 (U.S. Tax Ct., Aug 08, 1990) (NO. 26805-87)
84. EsC. I. R., T.C. Memo. 1990-359, 1990 WL 96986, 60 T.C.M. (CCH) 137, T.C.M. (P-H) 90,359 (U.S. Tax Ct., Jul 16, 1990) (NO. 37390-87)
85. Hight v. C. I. R., T.C. Memo. 1990-81, 1990 WL 14579, 58 T.C.M. (CCH) 1457, T.C.M. (P-H) 90,081 (U.S. Tax Ct., Feb 21, 1990) (NO. 21390-88)
86. Estate of Slater v. C.I.R., 93 T.C. No. 41, 93 T.C. 513, Tax Ct. Rep. (CCH) 46,114, Tax Ct. Rep. Dec. (P-H) 93.41 (U.S. Tax Ct., Oct 30, 1989) (NO. 7844-88)
87. Bank of West v. C.I.R., 93 T.C. No. 37, 93 T.C. 462, Tax Ct. Rep. (CCH) 46,084, Tax Ct. Rep. Dec. (P-H) 93.37 (U.S. Tax Ct., Oct 11, 1989) (NO. 23220-88)
88. Williamson v. C.I.R., 93 T.C. No. 23, 93 T.C. 242, Tax Ct. Rep. (CCH) 45,954, Tax Ct. Rep. Dec. (P-H) 93.23 (U.S. Tax Ct., Aug 21, 1989) (NO. 33059-87)
89. Estate of Maddox v. C.I.R., 93 T.C. No. 21, 93 T.C. 228, Tax Ct. Rep. (CCH) 45,924, Tax Ct. Rep. Dec. (P-H) 93.21 (U.S. Tax Ct., Aug 10, 1989) (NO. 9134-87)
90. Estate of Headrick v. C.I.R., 93 T.C. No. 18, 93 T.C. 171, Tax Ct. Rep. (CCH) 45,914, Tax Ct. Rep. Dec. (P-H) 93.18 (U.S. Tax Ct., Aug 07, 1989) (NO. 21659-86)
91. Estate of Evers v. C. I. R., T.C. Memo. 1989-292, 1989 WL 63156, 57 T.C.M. (CCH) 718, T.C.M. (P-H) 89,292 (U.S. Tax Ct., Jun 15, 1989) (NO. 33808-86)
92. Estate of Wood v. C.I.R., 92 T.C. No. 46, 92 T.C. 793, Tax Ct. Rep. (CCH) 9246, Tax Ct. Rep. (CCH) 45,604 (U.S. Tax Ct., Apr 12, 1989) (NO. 48020-86)
93. Estate of Strickland v. C.I.R., 92 T.C. No. 3, 92 T.C. 16, Tax Ct. Rep. (CCH) 45,412, Tax Ct. Rep. Dec. (P-H) 92.3 (U.S. Tax Ct., Jan 10, 1989) (NO. 41553-85)
94. Estate of Grimes v. C.I.R., T.C. Memo. 1988-576, 1988 WL 135011, 56 T.C.M. (CCH) 890, T.C.M. (P-H) 88,576 (U.S. Tax Ct., Dec 20, 1988) (NO. 33429-84)
95. Estate of Nesselrodt v. C.I.R., T.C. Memo. 1988-489, 1988 WL 98625, 56 T.C.M. (CCH) 452, T.C.M. (P-H) 88,489 (U.S. Tax Ct., Oct 11, 1988) (NO. 38921-84)
96. Estate of Christmas v. C.I.R., 91 T.C. No. 49, 91 T.C. 769, Tax Ct. Rep. (CCH) 45,118, Tax Ct. Rep. Dec. (P-H) 91.49 (U.S. Tax Ct., Oct 06, 1988) (NO. 12926-86)
97. Estate of Donahoe v. C.I.1988-453, 1988 WL 96218, 56 T.C.M. (CCH) 271, T.C.M. (P-H) 88,453 (U.S. Tax Ct., Sep 21, 1988) (NO. 28311-85)
98. Cokes v. C.I.R., 91 T.C. No. 19, 91 T.C. 222, Tax Ct. Rep. (CCH) 44,972, Tax Ct. Rep. Dec. (P-H) 91.19 (U.S. Tax Ct., Aug 15, 1988) (NO. 7435-84)
99. Estate of Killion v. C.I.R., T.C. Memo. 1988-244, 1988 WL 52652, 55 T.C.M. (CCH) 1004, T.C.M. (P-H) 88,244 (U.S. Tax Ct., May 31, 1988) (NO. 38967-84)
100. Estate of Bartberger v. C.I.R., T.C. Memo. 1988-21, 1988 WL 1958, 54 T.C.M. (CCH) 1550, T.C.M. (P-H) 88,021 (U.S. Tax Ct., Jan 19, 1988) (NO. 36710-85)
101. Estate of Di Fiore v. C.I.R., T.C. Memo. 1987-588, 1987 WL 49178, 54 T.C.M. (CCH) 1168, T.C.M. (P-H) 87,588 (U.S. Tax Ct., Nov 25, 1987) (NO. 3340-85)
102. Estate of Thompson (James U.), Taylor (Susan T.) v. Commissioner of Internal Revenue, 89 T.C. No. 43, 89 T.C. 619, Tax Ct. Rep. (CCH) 44,200 (U.S. Tax Ct., Sep 17, 1987) (NO. 9879-86)
103. McDonald (Gladys L.) v. Commissioner of Internal Revenue; Estate of McDonald (John), Cornelius (C.F.) v. Commissioner of Internal Revenue 89 T.C. No. 26, 89 T.C. 293, Tax Ct. Rep. (CCH) 44,118 (U.S. Tax Ct., Aug 18, 1987) (NO. 37673-84, 37694-84)
104. Estate of Heffley (Opal P.), Heffley (Timothy S.) v. Commissioner of Internal Revenue, 89 T.C. No. 23, 89 T.C. 265, Tax Ct. Rep. (CCH) 44,103 (U.S. Tax Ct., Aug 11, 1987) (NO. 3201-85)
105. Estate of Johnson (Curtis H.), Johnson (Kirby) v. Commissioner of Internal Revenue, 89 T.C. No. 13, 89 T.C. 127, Tax Ct. Rep. (CCH) 44,048 (U.S. Tax Ct., Jul 20, 1987) (NO. 37085-85)
106. Estate of Coffing v. C.I.R., T.C. Memo. 1987-336, 1987 WL 40391, 53 T.C.M. (CCH) 1314, T.C.M. (P-H) 87,336 (U.S. Tax Ct., Jul 08, 1987) (NO. 20452-81)
107. Estate of Ward (Rebecca), Emerson (Floral), Harris (Reba) v. Commissioner of Internal Revenue, 89 T.C. No. 6, 89 T.C. 54, Tax Ct. Rep. (CCH) 44,031 (U.S. Tax Ct., Jul 08, 1987) (NO. 20600-80)
108. Estate of Rothpletz v. C.I.R., T.C. Memo. 1987-310, 1987 WL 49207, 53 T.C.M. (CCH) 1214, T.C.M. (P-H) 87,310 (U.S. Tax Ct., Jun 24, 1987) (NO. 38934-84)
109. Estate of Gunland (Carl C.), Gunland Commissioner of Internal Revenue, 88 T.C. No. 81, 88 T.C. 1453, Tax Ct. Rep. (CCH) 43,955 (U.S. Tax Ct., Jun 04, 1987) (NO. 968-85)
110. Estate of Brandes v. C.I.R., 87 T.C. No. 33, 87 T.C. 592, Tax Ct. Rep. (CCH) 43,330 (U.S. Tax Ct., Sep 08, 1986) (NO. 27513-84)
111. Estate of Gardner v. C.I.R., T.C. Memo. 1986-380, 1986 WL 21590, 52 T.C.M. (CCH) 202, T.C.M. (P-H) 86,380 (U.S. Tax Ct., Aug 18, 1986) (NO. 28332-83)
112. Estate of Pliske v. C.I.R., T.C. Memo. 1986-311, 1986 WL 21519, 51 T.C.M. (CCH) 1543, T.C.M. (P-H) 86,311 (U.S. Tax Ct., Jul 24, 1986) (NO. 35008-04)
113. Estate of Nesselrodt v. C.I.R., T.C. Memo. 1986-286, 1986 WL 21992, 51 T.C.M. (CCH) 1406, T.C.M. (P-H) 86,286 (U.S. Tax Ct., Jul 14, 1986) (NO. 24902-82)
114. Estate of Davis v. C.I.R., 86 T.C. No. 67, 86 T.C. 1156, Tax Ct. Rep. (CCH) 43,105 (U.S. Tax Ct., Jun 11, 1986) (NO. 2383-82)

115. Estate of Clinard v. C.I.R., 86 T.C. No. 68, 86 T.C. 1180, Tax Ct. Rep. (CCH) 43,106 (U.S. Tax Ct., Jun 11, 1986) (NO. 6345-84)
116. Estate of Bettenhausen v. C.I.R., T.C. Memo. 1986-73, 1986 WL 21472, 51 T.C.M. (CCH) 488, T.C.M. (P-H) 86,073 (U.S. Tax Ct., Feb 18, 1986) (NO. 24133-82)
117. McCoy v. C.I.R., T.C. Memo. 1985-509, 1985 WL 15131, 50 T.C.M. (CCH) 1194, T.C.M. (P-H) 85,509 (U.S. Tax Ct., Sep 26, 1985) (NO. 19540-83)
118. Estate of Rubish v. C.I.R., T.C. Memo. 1985-406, 1985 WL 15027, 50 T.C.M. (CCH) 685, T.C.M. (P-H) 85,406 (U.S. Tax Ct., Aug 12, 1985) (NO. 15051-81)
119. Estate of Pullin, Black v. Commissioner of Internal Revenue, 84 T.C. No. 52, 84 T.C. 789, Tax Ct. Rep. (CCH) 42,060 (U.S. Tax Ct., May 01, 1985) (NO. 18606-82)
120. Martin by Martin v. Commissioner of Internal Revenue, 84 T.C. No. 40, 84 T.C. 620, Tax Ct. Rep. (CCH) 41,998 (U.S. Tax Ct., Apr 02, 1985) (NO. 10122-82, 10740-82)
121. Estate of Raab v. C.I.R., T.C. Memo. 1985-52, 1985 WL 14685, 49 T.C.M. (CCH) 662, T.C.M. (P-H) 85,052 (U.S. Tax Ct., Feb 04, 1985) (NO. 7327-83)
122. Estate of Flora J. Abell, Deceased, Juanita Abell Pyle, Executrix, Harry A. Waite, Executor, Petitioner v. Commissioner of Internal Revenue, Respondent, 83 T.C. No. 39, 83 T.C. 696 (U.S. Tax Ct., Nov 19, 1984) (NO. 24370-81)
123. Estate of Gardner v. Commissioner of Internal Revenue, 82 T.C. 82 T.C. 989, Tax Ct. Rep. (CCH) 41,293 (U.S. Tax Ct., Jun 25, 1984) (NO. 28332-83)
124. Estate of Williams v. C.I.R., T.C. Memo. 1984-178, 1984 WL 15498, 47 T.C.M. (CCH) 1479, T.C.M. (P-H) 84,178 (U.S. Tax Ct., Apr 10, 1984) (NO. 25089-82)
125. Estate of Sherrod v. Commissioner of Internal Revenue, 82 T.C. No. 40, 82 T.C. 523, Tax Ct. Rep. (CCH) 41,084 (U.S. Tax Ct., Mar 26, 1984) (NO. 5531-82)
126. Estate of Young v. C.I.R., T.C. Memo. 1983-686, 1983 WL 14674, 47 T.C.M. (CCH) 324, T.C.M. (P-H) 83,686 (U.S. Tax Ct., Nov 17, 1983) (NO. 29433-81)
127. Estate of Coon v. Commissioner of Internal Revenue, 81 T.C. No. 32, 81 T.C. 602, Tax Ct. Rep. (CCH) 40,478 (U.S. Tax Ct., Sep 22, 1983) (NO. 5758-81)
128. Estate of Boyd v. C.I.R., T.C. Memo. 1983-316, 1983 WL 14302, 46 T.C.M. (CCH) 328, T.C.M. (P-H) 83,316 (U.S. Tax Ct., Jun 06, 1983) (NO. 28651-81)
129. Estate of Cowser v. Commissioner of Internal Revenue, 80 T.C. 783, Tax Ct. Rep. (CCH) 40,054 (U.S. Tax Ct., Apr 25, 1983) (NO. 14699-82)
130. Estate of Geiger v. Commissioner of Internal Revenue, 80 T.C. 484, Tax Ct. Rep. (CCH) 39,936 (U.S. Tax Ct., Mar 07, 1983) (NO. 7354-81)
131. Estate of Gill v. Commissioner of Internal Revenue, 79 T.C. 437, Tax Ct. Rep. (CCH) 39,318 (U.S. Tax Ct., Sep 09, 1982) (NO. 21286-80)
132. Morris v. C.I.R., T.C. Memo. 1982-508, 1982 WL 10800, 44 T.C.M. (CCH) 1036, T.C.M. (P-H) 82,508 (U.S. Tax Ct., Sep 08, 1982) (NO. 1144-77)
133. Estate of Smith v. Commissioner of Internal Revenue, 77 T.C. 326 (U.S. Tax Ct., Aug 11, 1981) (NO. 16500-79)
134. Estate of Hankins v. C.I.R., T.C. Memo. 1981-326, 1981 WL 10627, 42 T.C.M. (CCH) 229, T.C.M. (P-H) 81,326 (U.S. Tax Ct., Jun 24, 1981) (NO. 8448-78)

Exhibit 2, An Example of How To Qualify Under Section 2033A

Aggregate Value of all qualified family owned business interests that are included in the gross estate and are acquired by or passed to a qualified heir from decedent (AV) = \$11,000,000

Adjusted Taxable Gifts of qualified family owned business interests to family members if still held by family member (ATG) = \$2,000,000

Gifts Not covered by Annual gift tax Exclusions made within 3 years of death (GNAE) = \$3,000,000

Cash or marketable securities that exceed reasonably expected day-to-day working capital needs, i.e., Excess Liquidity (EL) = \$1,000,000

Total Indebtedness of decedent (TI) = \$5,000,000

Qualified acquisition indebtedness for personal residence, i.e. Personal residence Mortgage (Mort) = \$2,000,000

Debt to pay Education or Medical expenses (EdMed) = \$200,000

Other Debt up to \$10,000 (OD) = \$10,000

Decedent's Gross Estate without regard to Section 2033A (GE) = \$15,000,000

Gifts to Spouse within 10 years of death (other than GNAE above) (GSP) = \$1,000,000

Nontaxable Gifts within 3 years of death (NTG) = \$500,000

$$\begin{aligned}
& \frac{AV + ATG - GNAE - EL - (TI - Mort - EdMed - OD)}{GE - TI + GNAE + GSP + NTG - GNAE} > \frac{1}{2} \\
& \frac{\$11,000,000 + 2,000,000 - 3,000,000 - 1,000,000 - (5,000,000 - 2,000,000 - 200,000 - 10,000)}{\$15,000,000 - 5,000,000 + 3,000,000 + 1,000,000 + 500,000 - 3,000,000} \\
& = \frac{\$6,210,000}{\$11,500,000} \\
& = .54 > \frac{1}{2}, \text{ therefore Section 2033A applies.}
\end{aligned}$$

Chairman ARCHER. Thank you, Mr. Apolinsky, for some very, very incisive testimony.

Our last witness on this panel is Charles Kruse, and if you will identify yourself for the record, we would be pleased to receive your testimony.

STATEMENT OF CHARLES E. KRUSE, PRESIDENT, MISSOURI FARM BUREAU FEDERATION; AND MEMBER, BOARD OF DIRECTORS, AMERICAN FARM BUREAU FEDERATION

Mr. KRUSE. Thank you very much, Mr. Chairman.

My name is Charlie Kruse. I am a fourth generation farmer and operate a corn, cotton, soybean, and wheat farm in Stoddard County, Missouri. I serve on the board of directors of American Farm Bureau Federation and as president of Missouri Farm Bureau Federation. My statement today is made on behalf of the 4.7 million families who belong to the American Farm Bureau Federation.

Production agriculture is a capital intensive industry with total assets of more than \$1 trillion. Yet, despite its size, it is an industry dominated by family businesses, many of which are multigenerational.

As I attend farm meetings across Missouri and the United States, I realize that many others like me are concerned about transferring our farm businesses to our sons and daughters when we die. Like me, they worry about the negative impact of estate taxes.

When you consider that 47 percent of farm and ranch operators today are 55 years or older, you realize that agriculture is fast approaching a transformation.

The Farm Bureau's position on estate taxes is very straightforward. We recommend repeal. Until repeal is possible, we support increasing the exemption to \$2 million and indexing it for inflation. For assets over \$2 million, the tax rate should be cut in half.

Farmers and ranchers work long, hard hours over a lifetime to build their businesses. Along the way, they paid income taxes on

their earnings, and it is wrong to tax those earnings again at death.

Two million dollars may seem like a lot of money, but for many farmers and ranchers, it is simply a family business. A typical example of this would be a California family farm that may involve 1,000 or 2,000 acres. When you combine \$2,400 an acre farmland with the value of the other business assets, the total worth of a farm supporting one or two families can easily top \$2 million.

Failure to increase the exemption discourages the continuation of family farms in this country. Often, farm heirs must sell business assets to pay estate taxes. When taxes drain too much capital from a farm business, the profitmaking ability of the farm is destroyed, and the farm business dies.

A Missouri Farm Bureau member recently shared his story with me. His family's farm was purchased in 1919 for \$3.50 an acre. Today, the farm has an appraised value of \$1.7 million. The land, now planted with trees, happens to be located near the city of Branson, with its value based not on agriculture use but on commercial value. This family can donate the property to a church or even to a university with little or no tax liability. However, if the land is passed onto their children, the estate tax has been estimated at more than \$½ million. Their heirs would be forced to sell a large portion of the farm just to pay the tax, bringing into question the economic viability of the smaller farm operation.

The estate tax has essentially precluded this farm from being passed onto a fourth generation and will simply accelerate its transition into development and out of agriculture.

While the focus of this panel is estate taxes, I would also like to make a comment or two regarding the capital gains tax because cutting this tax is also a priority for the Farm Bureau.

The Farm Bureau supports repeal of capital gains taxes. Until repeal is possible, we support cutting the rate to no more than 15 percent. Also, capital gains should be indexed for inflation.

Capital gains taxes result in the double taxation of income from capital assets. I don't know any farmers who have bought farmland, buildings, equipment, or livestock with untaxed dollars. It is wrong to tax earnings twice. The practice interferes with the sale of farm assets and causes asset allocation decisions to be made for tax reasons rather than business reasons.

Capital gains taxes affect the ability of new farmers and ranchers to enter the industry and expand their operations. While many think of the capital gains tax as a tax on the seller, in reality, it is a tax on the buyer. Older farmers and ranchers are often reluctant to sell assets because they don't want to pay the capital gains taxes. Therefore, buyers must pay a premium to acquire assets in order to cover the taxes assessed on the seller.

American farmers and ranchers are the most productive in the world, producing 16 percent of the world's food on just 7 percent of the land. Farm and ranch productivity allows U.S. citizens to spend only 9.3 percent of their income on food, the lowest percentage in the world.

Agriculture and related industries provide jobs for more than 21 million people in this country. In order for farmers and ranchers to continue this high level of productivity, reforms must be made

in capital gains and estate taxes. These changes will benefit farmers, consumers, and the economy.

Mr. Chairman, I thank you for the opportunity to testify before the Committee today and look forward to answering any questions you might have.

[The prepared statement

Statement of Charles E. Kruse, President, Missouri Farm Bureau Federation; and Member, Board of Directors, American Farm Bureau Federation

My name is Charlie Kruse. I am a fourth generation farmer who operates a 600-acre corn, wheat, cotton and soybean farm in Stoddard County, Missouri. I serve on the Board of Directors of the American Farm Bureau Federation and as president of the Missouri Farm Bureau Federation. My statement today is made on behalf of the 4.7 million families who belong to the American Farm Bureau Federation.

Production agriculture is a capital intensive industry with total assets of more than \$1 trillion. Yet, despite its size, it is an industry dominated by family businesses, many of which are multi-generational. Like so many of my fellow farmers, the operation of my business involves family members. My wife, Pam, and children, Scott and Ben, are my partners and, in fact, keep things going when I am away on Farm Bureau business.

As I attend farm meetings across Missouri and the United States, I realize how many others, like me, are concerned about transferring our farm businesses to our sons and daughters when we die. Like me, they worry about the negative impact the capital gains tax has on the operation of our businesses. When you consider that 47 percent of farm and ranch operators are 55 years or older, you realize that agriculture is fast approaching a transformation.

The timing of this hearing on estate and capital gains taxes could not be better. The Administration's budget proposes expanding the exclusion of capital gains on the sale of an individual's principal residence and expanding the estate tax extension provisions for closely held businesses. While we are encouraged that the President raises the capital gains and estate tax issue, the changes he proposes are inadequate to address the needs of production agriculture. Narrowly targeted changes will not provide the relief needed by farmers, ranchers and other rural agricultural businesses.

Estate and capital gains taxes greatly impact the efficient use of farm capital and the transfer of assets from one generation to another. Estate and capital gains tax reform is long overdue. Thank you for providing this forum where the reasons for reform can be put forward and for allowing me to speak today.

ESTATE TAXES

Farm Bureau's position on estate taxes is straightforward. We recommend repeal. Farmers and ranchers work long, hard hours over a lifetime to build their businesses. Along the way they paid income taxes on their earnings and it is wrong to tax those earning again at death. Farmers and ranchers should be able to save for the future without having to worry about sharing the outcome of their efforts with the federal government after already paying a lifetime of income taxes. Family farms and other family businesses should be passed from generation to generation without complex and costly estate planning.

Until repeal is possible, Farm Bureau supports increasing the exemption to \$2 million and cutting the tax rate by half for assets over \$2 million. The gift tax should be increased from \$10,000 to \$50,000 per year. These changes would lift the burden of estate taxes for thousands of farmers and ranchers. Internal Revenue Service figures show that by increasing the estate tax exemption to \$1 million, over 37,000 estates, 54 percent of the returns filed, would no longer have to file estate tax forms.

A \$2 million exemption would eliminate the tax on most farms and ranches. Failure to increase the exemption discourages the continuation of family farms. Often, farm heirs must sell business assets to pay estate taxes. When taxes drain capital from a farm business, the profit-making ability of the farm is destroyed and the farm business dies.

The story of a Fauquier County, Virginia, farmer makes clear the need for estate tax reform. His wife inherited an 85-acre beef farm that he now operates with his family. Through extensive estate planning and use of Section 2032A special use valuation, a portion of the farm was passed from father to daughter. The family wants to continue to farm but will be unable to pay the estate taxes on the mother's

portion because the tax due will exceed their ability to pay. When asked if selling a part of the farm to obtain cash was an option, he said, There won't be much left.

The estate tax exemption hasn't been increased since 1987. Since then, average prices in the U.S. economy have increased by 35 percent. Farm Bureau believes that the exemption should be increased to \$2 million and indexed for inflation. This would provide the same protection from inflation as is provided by the adjusting of income tax brackets, personal exemptions and the standard deduction.

Two million dollars may seem like a lot of money to some. But for many farmers and ranchers, it is simply a family business. According to USDA estimates, average farmland in California in 1996 was valued at about \$2,400 an acre. A multi-generation family farm may involve 1,000–2,000 acres. One thousand acres of land at \$2,400 per acre is worth \$2.4 million. That doesn't include buildings, livestock, farm equipment and other assets whose value would easily be worth another third of a million dollars on a 1,000-acre farm.

Some people argue that estate taxes do not impact small business if estate planning is effectively used. While sometimes effective at protecting farm businesses from estate taxes, estate planning tools and life insurance are costly and constantly drain resources that could be better used by farmers and ranchers to upgrade and expand their operations.

The situation of an orchard and farm market operation in Allegheny County, Pennsylvania, illustrates this point. Knowing that the estate tax burden will be great, this family operation of a mother, father and four children has developed an estate plan requiring money to be set aside for estate taxes. The amount of money that the business puts into a trust each year is almost as great as the individual earnings of each of the children. According to the family, this significantly reduces funds for things that the farm could use to operate more efficiently, like equipment purchases and building improvements.

The Virginia and Pennsylvania examples show that the estate tax is not a tax on the rich, as opponents of estate tax cuts argue, but rather a penalty on middle-class men and women who chose to make their living by operating their own businesses. Internal Revenue Service data from 1995 clearly shows that those with the greatest worth are also the best at using estate tax planning to reduce or eliminate taxes at the time of death.

While farmers spend hundreds of hours and thousands of dollars for estate plans and life insurance, relatively little revenue is generated for the federal government. In fact, Internal Revenue Service figures for 1995 show 54 percent of returns (37,000 estates) had assets of less than \$1 million and generated only \$650 million. The estate tax raised a total of about \$17.2 billion in fiscal year 1996, as reported by the Office of Management and Budget. But, the estate tax can also cause huge revenue losses. People who believe they will be subject to the estate tax seek ways to transfer assets to avoid the tax. That often includes investing in less productive assets that reduce taxable income in the short term.

It follows that one of the reasons that revenue collected from the estate tax is low is that not very many people pay the tax. During 1995, 31,565 estates paid estate taxes. This is roughly 1.4 percent of the estimated 2.3 million adults who died that year. Opponents of estate tax reform say there is no reason to change a tax that affects so few middle-income Americans. But each death affects children, grandchildren and other close family members. The impact is greatest for multi-generation family farms and ranches and other family businesses.

Farm Bureau supports changes in Section 2032A of the tax code that allows land to be appraised at its agricultural value for estate tax purposes. While beneficial to farms that operate near towns and parks, the amount that land value can be reduced is limited to \$750,000. Use valuation is sound public policy and the limit should be removed so that the program can be applied to all farm and ranch land.

In addition, Section 2032A requires that the land be kept in agricultural production and operated by the heirs for 10 years. The rules have become so complex that some choose not to use the program because they fear they may not be able to comply with all the rules. Farm Bureau recommends improvements in the law so that cash leasing to family members and the harvest of timber does not trigger the recapture of estate taxes.

Farm Bureau also supports the deferral of estate taxes until a farm is sold outside the family. In addition, land protected by a conservation easement or participating in a farmland preservation program should not be subject to estate taxes.

CAPITAL GAINS TAXES

Farm Bureau supports repeal of capital gains taxes. Until repeal is possible, Farm Bureau supports cutting the rate to no more than 15 percent. Capital gains taxes

result in the double taxation of income from capital assets. I don't know any farmers who have bought farmland, buildings, equipment or livestock with untaxed dollars. It is wrong to tax earnings twice. In addition, the tax interferes with the sale of farm assets and causes asset allocation decisions to be made for tax reasons rather than business reasons. The result is the inefficient allocation of scarce capital resources, less net income for farmers and reduced competitiveness in international markets.

Farmers need capital gains tax relief in order to ensure the cost and availability of investment capital. Access to affordable capital influences agriculture's ability to compete with overseas production. Most farmers and ranchers have limited sources of outside capital. It must come from internally-generated funds or from borrowing from financial institutions. The capital gains tax reduces the amount of money available for reinvestment by farmers and ranchers. Financial institutions look closely at financial performance, including the impact of the capital gains tax on the profit-making ability of a business.

Capital gains taxes affect the ability of new farmers and ranchers to enter the industry and expand their operations. While many think of the capital gains tax as a tax on the seller, in reality it is a penalty on the buyer. Older farmers and ranchers are often reluctant to sell assets because they do not want to pay the capital gains taxes. Buyers must pay a premium to acquire assets in order to cover the taxes assessed on the seller. These higher costs for asset acquisition negatively impact the ability of new and expanding farmers and ranchers to make a profit and compete in international markets.

Farm Bureau supports adjusting capital gains for inflation so that only real gains in the value of assets would be taxed. Under current law, many farmers and ranchers pay an effective tax rate that is extreme and sometimes end up paying more in capital gains taxes than the increase in the real value of the assets. Farmers and ranchers are reluctant to sell land and farm assets and reinvest in other assets, even when that may make the best business sense. For assets held for long periods of time, adjusting their value for inflation is a matter of fairness.

Farmland provides a good example. Farmers and ranchers on average hold farmland for about 30 years. In 1966, farmland in Missouri was selling for an average of \$142 per acre. In 1996, the average was \$948. A farmer who bought 300 acres of land in 1966 for \$42,600 and sold it in 1996 would have a taxable gain of \$241,800 and owe \$67,704 at a 28 percent tax rate. Average prices in the U.S. economy are now 4.26 times what they were 30 years ago. This means that the real increase of value on those 300 acres was \$102,924, making the effective tax rate on the real capital gain 66 percent.

Farm Bureau supports allowing receipts from the sale of farm and ranch assets to be placed directly into a pre-tax individual retirement savings account (IRA). Withdrawals would be taxed at the regular applicable income tax rate. Farm and ranch assets accumulated over a lifetime are often the "retirement plan" for farmers and ranchers. Allowing these funds to be placed into a pre-tax account would treat farmers and ranchers in the same manner as other taxpayers who contribute to IRAs throughout their working life.

A similar result for yearly income could be achieved by allowing farmers and ranchers to establish individual risk management accounts. Taxes on money placed in these accounts would be deferred, as with IRAs. Farmers and ranchers could manage risk by saving during profitable years for those years that are not. Funds would be taxed at the holder's regular tax rate at withdrawal. Because farmers and ranchers could save money before taxes in high-income years and draw that money out in low-income years, they would pay taxes at a rate similar to people earning the same aggregate amount with more stable incomes.

Farm Bureau also believes that the current once-in-a lifetime exclusion of \$125,000 on the sale of a primary residence by a taxpayer over 55 years of age should be increased to \$500,000 and expanded to include farms and ranches. The exclusion should not be limited to a single use by a taxpayer over age 55 and, if not used, should be added to an individual's estate tax exemption.

TAX REFORM

Farm and ranch concerns over capital gains taxes and estate taxes raise many questions about the need to fundamentally reform the current tax system. Consideration should be given to a new and different taxing systems that encourage savings, investment and entrepreneurship. Changes are needed to simplify tax laws, reform Internal Revenue Service rules and regulations and simplify tax forms. Fundamental tax reform which completely replaces the current personal income tax and corporate income tax should eliminate estate taxes and capital gains taxes.

CONCLUSION

American farmers and ranchers are the most productive in the world, producing 16 percent of the world's food on just 7 percent of the land. Farm and ranch productivity allows U.S. citizens to spend only 9.3 percent of their income on food, the lowest percentage in the world.

Agriculture and related industries provide jobs for more than 21 million people. Nearly 3.5 million people operate farms or work on farms. Another 3.6 million produce the machinery and inputs used on the farm or process and market what farmers produce. More than 14 million work in wholesale or retail businesses helping get farm products from the farm to consumers.

In order for farmers to continue this high level of productivity, reform of estate tax and capital gains tax laws is needed without delay. The results will benefit farmers, consumers and the economy.

Chairman ARCHER. Thank you, Mr. Kruse.

I compliment each of you for your testimony. We would prefer to go on to the questioning, but I want it to be clear in the record that when I came to Congress in 1971, I had the goal of repeal of the estate tax, now the death tax, which is what we should all call it today because that is what it is, and the repeal of the capital gains tax, completely and totally. We haven't gotten that done in the 26 years that I have been in the Congress, but I think we are closer today than we have ever been toward that ultimate goal.

I fear that we will not get it by incremental changes in the current Income Tax Code, and that is one of the reasons why I have made the decision that the only way to go is to abolish the income tax and abolish the death tax, completely and totally, and replace it with a tax on consumption.

This country should not have any taxes on capital savings anywhere on the books if we want to prosper and create jobs and a better opportunity for Americans in the years to come.

In one fell swoop, we could eliminate all of it by eliminating the corporate income tax, the individual income tax, and the death tax. We are in a tax trap in the United States today. The longer you work, the harder you work, the more you pay to the Government; and the more you pay to the Federal Government, the more the Congress spends, and then the sequence continues, and the more they spend, the more you have to work and the longer you have to work and the more you have to pay. It shouldn't be that way. It should be that the more you spend, the more you pay, which is a far fairer system. But my goal is to completely get rid of the capital gains tax, the death tax, and to get the IRS completely and totally out of the lives of every individual American.

I particularly applaud Mr. Apolinsky because it takes a true patriot to come before this Committee and argue against his own personal best financial interest. That is very rare, indeed, in this country, and I compliment you for that.

I don't have any questions of you because we are in harmony. It is just a question of how much we can get done, but I am sure there are other Members of the Committee that would like to inquire.

Mr. Hulshof.

Mr. HULSHOF. Thank you, Mr. Chairman.

First of all, we appreciate your testimony. Mr. Kruse, in particular, you and I have known one another for years, and I see that you have got a strong contingent from the show-me State that are here to support your efforts, and it is great to see some constituents and others from the show-me State here.

As you know, Charlie, as the only son of a Missouri farm family, I know firsthand some of the effects of the death tax, and particularly as those of us who have worked for the American dream, suddenly that American dream turning into a nightmare as we wake up to the fact of whether it is small business or having to liquidate its assets or having to sell off a piece of farm and having it auctioned on the auction block just to pay the Federal Government.

I know our family, as well as many other hard-working men and women across this country, have invested not only our money, but our hearts and souls into something that we would like to pass on as a legacy to our descendants. We have taken the risks. We have navigated those treacherous straits of regulations, and then, just as we see open seas and hopefully calmer waters ahead of us, then the Federal Government sends a tidal wave crashing over our bows, and there we go.

So I appreciate, Mr. Kruse, all you and the Farm Bureau are doing to help us get that message out across the country, and the rest of you as well.

Mr. Danner, I also note from your testimony you mentioned section 6166 and the loan program. I am a bit disappointed with the administration's proposal just to expand this loan program. I have spoken personally to members of the administration that this does not nearly provide the tax relief we need in this area. Each of us, I think, probably brings horror stories to bear, but just this past weekend, when I was back home in the District, an individual, a 64-year-old man, told me about the fact he was in his 10th year of an installment loan that he had to take out just to pay the tax, and he is disabled and now is looking to pass on that small business to his son, and that he was trying to create some innovative way so that his son would not have to rely upon taking out a loan to pay the tax bill.

As a final comment, maybe a couple of questions, Mr. Apolinsky, and this is the kind of information I have been looking for as far as the actual amount of moneys. You mentioned the Kennesaw State College study regarding the Associated Equipment Distributors, and I note that—is it just for that AED group, that about \$5 million was spent in life insurance premiums and another \$6.5 million on lawyers and accountants and other services?

Mr. APOLINSKY. Yes.

Mr. HULSHOF. Any data or survey information? Can we extrapolate that number out across the United States in some sort of an estimate? Do any of you have that information as to how much money hard-working families either spend on insurance policies or that hire your services, Mr. Apolinsky, or others in an effort to legally try to avoid the estate tax? Do we have a figure or an estimate as to how much money we have to expend in that regard?

Mr. APOLINSKY. I have never seen that number quantified. It is, as you anticipate, a huge industry today. If you combine the accounting fees, the legal fees, the financial planning fees, the last-

to-die life insurance, which is only sold for estate taxes—I have got a client. He told me I could share with you his story.

He is a bottler in Birmingham. In order to try to get the business through the third generation, they have purchased \$180 million of last-to-die life insurance. The premium is \$1.5 million after tax. Now, that business has stopped expansion.

It used to expand, provide more jobs, but that was the seed money that they use for leverage to expand, and they are no longer able to expand.

I see it as they did in Australia. In Australia, they repealed the estate tax in 1977 because they wanted family businesses, farms, capital to grow larger to provide jobs. I really see that as businesses are sold and liquidated and farms are sold, jobs are lost. We are not redistributing wealth, but concentrating ownership in some large multinational companies that are not affected by this tax. This tax is costing a lot of jobs. It will be amazing over the next 20 years how many jobs will be lost from this tax if we don't grab it now. I certainly applaud what the Chairman said. Hopefully, we are so close to getting it repealed. It is an exciting time from my perspective.

Mr. CRANE. Mr. Hulshof, would you yield for just a second?

Mr. HULSHOF. I would be happy to yield.

Mr. CRANE. I think it was Investors Business Daily, in a January publication, that indicated that estate tax compliance costs are estimated to be 65 cents for every dollar of revenue in.

Mr. HULSHOF. If the Chairman would yield just for a final comment.

Mr. Crane, I appreciate the opportunity to join with you as a new Member as we have introduced our own bills to completely repeal the death tax.

Mr. Chairman, this is, of course, my first term, and I certainly hope it doesn't take as long to get to that final result as it has from your first term. I appreciate the opportunity.

Thank you, panelists.

Chairman ARCHER. Does any other Member wish to inquire?

Mr. Ramstad.

Mr. RAMSTAD. Very briefly, Mr. Chairman.

I want to thank the witness from Missouri for sending us our newest Member who is doing an outstanding job on the Ways and Means Committee, and also, I want to thank you, Wayne Nelson, for being here today from Minnesota and for all the excellent work you do back home. I appreciate your contribution to this effort.

I think working together in a collaborative way as we are, we can get it done this year. So, we really appreciate your being here and your help in this regard.

Thank you, Mr. Chairman.

Chairman ARCHER. I might say that Mr. Crane, who just commented briefly, has been here slightly longer than I have, and he has been trying even longer than I have to repeal the death tax and the capital gains tax.

Mr. CRANE. You have from the beginning.

Chairman ARCHER. Gentlemen, thank you very much for your testimony. It has been exceedingly helpful. We wish you a good day, and we hope we don't have to see you back here again.

Mr. WHELAN. Thank you, Mr. Chairman.

Mr. DANNER. Thank you.

Chairman ARCHER. Our next panel will prepare to take seats at the witness table; James Higgins, Paul Yakoboski, Bennie Thayer, and William Gale.

Welcome, gentlemen. As I said earlier, if you will make every effort to limit your verbal testimony to 5 minutes, your entire written statement will be printed in the record.

Mr. Thayer, would you like to lead off? Identify yourself for the record, and then we will be pleased to receive your testimony.

STATEMENT OF BENNIE L. THAYER, PRESIDENT, NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED; ON BEHALF OF SAVINGS COALITION OF AMERICA

Mr. THAYER. Thank you very much, Chairman Archer. I am Bennie L. Thayer. I am president of NASE, the National Association for the Self-Employed. The NASE represents more than 325,000 very small businesses, and these businesses generally have between zero to four employees. The rest are self-employed individuals that run their own businesses. They reside in all 435 of the congressional districts.

I also appear here today on behalf of the Savings Coalition of America. This is a coalition of 65 member organizations supporting incentives to increase personal savings.

The NASE and the Savings Coalition, Mr. Chairman, are committed to expanding individual retirement accounts. We strongly support the features of H.R. 446, the Savings and Investment Incentive Act of 1997.

As you are all aware, and especially you, Mr. Chairman, the rate of personal saving in the United States has significantly decreased in the past three decades, from 8 percent in the sixties to about 4 percent to date. This is the lowest it has been in the United States since World War II.

When compared to the other industrialized nations, the rate of personal savings in the United States is one of the lowest.

Saving is also a key component of the National Economic Policy. Increased personal saving rates not only benefit individual Americans, but also provide the economy with the investment capital it needs to grow. More saving equals more funds available for lending, and for those of us in small business, that represents more money for loans.

Let us talk about small business and retirement for the moment. Retirement income comes from three source: First of all, Social Security; second, pensions; and third, personal savings.

We don't know what Social Security will be like in 20 years, that is for sure, but it is very unlikely that today's structure of benefits and tax levels can be maintained.

What about the pensions? Despite the good work of this Committee, Mr. Chairman, and the others in Congress last year, when you passed the SIMPLE plan, the plain truth is that the kind of entrepreneurs we represent within the NASE typically do not have pensions. And that is a fact. Our members just don't have pensions, nor do a great many of other small businesses in America.

That leaves personal savings as the third category for retirement. We have surveyed our NASE members on retirement plans. Over 60 percent—60 percent of these typical smallest of small business people have put away less than \$50,000 for their retirement, and 40 percent have saved less than \$20,000. This is even true for people who are now in their fifties. Yet, a typical length of retirement today is about 15 years. Now, it doesn't take a lot of higher mathematics to see that many small business people are going to be in big trouble if we don't get them to save more and to save more soon.

Due to the income limits on IRAs and the Tax Reform Act of 1986, IRA contributions have dropped by more than 40 percent among those who continue to be eligible for tax-deductible IRAs, largely because aggressive IRA marketing has declined. IRAs have declined and have been restricted since 1986.

Before 1986 when tax-advantaged IRAs were available to everyone, banks, mutual funds, brokerage houses, and insurance companies all competed to sell savings. We need to have this happen again in America. We really need to have this happen again. An IRA that is available to all Americans will make it happen again, and we firmly believe that.

The Savings Coalition and the NASE urges lawmakers to keep IRAs simple and easy to understand. Therefore, we firmly support H.R. 446.

Mr. Chairman, in conclusion, let me simply say this to you. Regarding the tax benefits from the \$2,000 cap that presently exists for IRAs, you will hear that it is really there for the rich. We say to you here today that for many Americans, that \$2,000 represents their only chance to save. It is for that reason we support and ask you and this Committee to firmly get behind H.R. 446 and assert to you today that we will do everything within our power to support you.

Thank you.

[The prepared statement and attachment follow:]

Statement of Bennie L. Thayer, President, National Association for the Self-Employed; On Behalf of Savings Coalition of America

Good Morning. My name is Bennie L. Thayer, and I am the President of the National Association for the Self-Employed. I submit this testimony on behalf of the Savings Coalition of America. The Savings Coalition consists of 65 member organizations representing the interests of tens of millions of American savers. Established in 1991, the Savings Coalition membership includes a wide variety of interests including consumer, health care, education and business groups, engineers, home-builders, realtors, trust companies, banks, securities firms, insurance, and financial service companies. The Savings Coalition supports incentives to increase the rate of personal saving in the United States.

EXPANDED INDIVIDUAL RETIREMENT ACCOUNTS

When Americans retire they rely on three sources of income—Social Security, pensions and personal savings. Individual Retirement Accounts (IRAs) fall in the category of personal savings. The Savings Coalition is committed to seeking the enactment of expanded IRA legislation and strongly supports the features of H.R. 446, The Savings and Investment Incentive Act of 1997. The Savings Coalition believes that tax and economic policy should provide more opportunity and incentive for Americans to save and invest for their futures. The Savings and Investment Incentive Act of 1997 has features that provide incentives and opportunities to save for all Americans. It also provides the intangible values of responsibility and self-reliance for people through those provisions.

COUNCIL FOR ECONOMIC DEVELOPMENT FINDINGS OF AMERICAS RETIREMENT
SITUATION

In May 1995, the Council for Economic Development (CED) released its report entitled, *Who Will Pay For Your Retirement? The Looming Crisis*. In its findings, the CED found that this countrys retirement system is in dire straits and unless corrective action is taken soon, America will be confronting a major economic crisis. The CED report concluded that Americas retirement system is underfunded, overregulated, and soon to be challenged by unprecedented growth in the retirement-age population. Consequently, our nation will confront a major crisis in financing the needs of the elderly at the beginning of the twenty-first century unless policies are reformed to make retirement saving a top priority. One of the recommendations of the CED is the implementation of tax incentives and regulatory reform to encourage individual retirement saving and to achieve increased funding of, and coverage by, private pensions. H.R. 446 provides all Americans with the savings incentives for retirement which are critical when one considers the problems illuminated by the CED in its report.

LOW RATE OF SAVING IN THE UNITED STATES

Saving is a key component of economic policy. Increased personal saving rates not only benefit individual Americans, but also provide the economy with the investment capital it needs to grow. Improving the saving rate increases the nations store of funds available for lending that helps small businesses when they need loans.

The rate of personal saving in the United States has significantly decreased in the past three decades—from 8% in the 1960s to hovering around 4% today. This current rate is the lowest it has been in the United States since World War II. When compared to other industrialized nations, the rate of personal saving in the US is one of the lowest. Americans are saving less than one-half as much as the Germans and one-third as much as the Japanese. We can do something about the low rate of saving by taking a bite out of our federal deficit. But, we must also do something to change peoples attitudes towards savings. The universally available IRA is the best vehicle we currently have to get that done.

Over the past several years, a significant amount of academic research on the effectiveness of IRAs has been published. Top academic economists have found that IRAs increase saving. The list includes Martin Feldstein (Harvard), David Wise (Harvard), Treasury Deputy Secretary Lawrence Summers (former Harvard economist), James Poterba (MIT), Steven Venti (Dartmouth), Jonathan Skinner (University of Virginia), Richard Thaler (Cornell) and Glenn Hubbard (Columbia).

It is less well-known that, because of the low personal saving rate in the US, America has become increasingly dependent on foreign investors to finance the US debt. Regardless of the progress made toward balancing the budget, the US must still finance an outstanding debt of more than \$5 trillion by selling Treasury securities. In the past few years, foreign investors have become the dominant force in the market for these Treasury securities.

According to an analysis conducted by the Securities Industry Association, in 1995, for instance, net purchases of US Treasury notes and bonds by foreigners reached \$134 billion. The analysis further revealed that in 1996 the pace of foreign acquisitions of Treasury securities accelerated. According to the US Department of Treasurys Office of Market Finance, at the end of 1996, foreigners owned 31.6% of the total private holdings of US Treasury securities, up from 21.7% at the end of 1994.

This trend means that the favorable interest rate environment that we have enjoyed in the US is vulnerable to the vagaries of investing by foreigners. If they substantially reduced their purchases of US Treasury securities, the interest rate on such securities would probably rise and accordingly so would interest rates on corporate bonds as well as mortgages and bank loans. In other words, a key component of economic health in the US is heavily influenced by the investment decisions of foreign savers.

IRAS SHOULD BE AVAILABLE TO ALL AMERICANS

An interesting effect of the implementation of income limits on universally available IRAs in the Tax Reform Act of 1986 is that IRA contributions have dropped by more than 40% for those who continued to be eligible for deductible IRAs. The decline in IRA contributions is partially attributed to misunderstanding on the part of Americans as to their eligibility for IRAs and a decline in marketing of IRAs by financial institutions. Before 1986, the IRA worked to increase savings because we had banks, mutual funds, brokerage houses and insurance companies competing to

sell savings. Instead of selling goods, Madison Avenue was selling investment. Universal availability of IRAs—a savings incentive available to everyone—is what led to the advertising of IRAs in the mid-80s. This is the kind of advertising we need again if we are to get people refocused on the importance of saving. An IRA that is available to all Americans will reduce confusion on the part of individuals and increase the marketing of IRAs on the part of financial institutions. The Savings Coalition urges lawmakers to keep IRAs simple and easy to understand. Limiting IRA eligibility confuses people and scares them away from establishing a pattern of savings that IRAs would otherwise promote.

The Savings and Investment Incentive Act of 1997 benefits all Americans—it gives an incentive to everyone who wants to take advantage of it. The first home withdrawal features and the IRA Plus account are very attractive to the young, even if they do not have children. The education expansion provides a strong incentive for people with children. The expanded retirement savings vehicles in both the traditional IRA and the IRA Plus are popular with people in their 50s and early 60s who see retirement just around the corner.

EXPANDED IRAS ENJOY BROAD SUPPORT AND ARE POPULAR WITH AMERICANS

Expansion of IRAs is not only an area of agreement on both sides of the aisle in Congress, but also down Pennsylvania Avenue between Congress and the White House. The 1996 Republican and Democratic National Platforms included expanded IRAs.

In December 1995 and May 1996, the Savings Coalition commissioned polls of registered voters regarding their preference of items included in the tax cut proposals. In the December 1995 poll conducted by Lake Research, 7 out of 10 registered voters said they would increase their rate of personal saving if IRAs were expanded to allow Americans to save. Also, middle class Americans choose expanded IRAs above a child tax credit and the capital gains tax cut as the tax proposal the country should adopt first. In May 1996 a bipartisan poll was conducted by Lake Research and the Luntz Research Companies. The results of the poll indicated that more than 6 out of 10 American voters (64%) claimed that they would increase their rate of personal saving if IRAs were expanded to allow more Americans to save. In addition, the heart of the American workforce, voters aged 30 to 64 favored the expansion of IRAs (35%) to a cut in capital gains or a child tax cut.

In February 1997, the NASDAQ Stock Market, a member of the Savings Coalition, surveyed investors and potential investors. An interesting finding of the survey is that those who are investing their money are relying on their personal investments to fund their retirement. Forty-one percent of investors say that most of the money for their retirement will come from savings and investments, while just twenty-nine percent say it will come from a retirement plan (25%) or Social Security (4%). Americans plan to save and invest more for their retirement and the provisions in H.R. 446 will provide them with an incentive to do that.

In a 1995 poll conducted by Dr. Frank Luntz of Luntz Research Companies for Merrill Lynch, one of the members of the Savings Coalition, it was revealed that an overwhelming majority of Americans do not believe that Social Security or Medicare will provide them with peace of mind in retirement. The poll also found that a majority of Americans feel that government policies do not encourage retirement saving. Similar to the results of the polls conducted by the Savings Coalition, this poll found that among the various proposed forms of tax relief, Americans believe that expanding the IRA should be the highest priority.

Other members of the Savings Coalition have conducted polls with similar results. In August 1995, Dean Witter, Discover; Company conducted a survey of its clients on their attitudes and behaviors towards savings, preparing for retirement and opinions towards the IRA legislation being considered. Most of the clients felt that the current tax laws do not encourage enough savings and that the expansion of IRAs proposed by Congress would encourage them to save more for retirement. Another interesting finding in the survey is that the primary reason cited by Dean Witter clients for *not* contributing to an IRA is the lack of tax advantages for doing so. In a poll conducted by the Institute of Electrical and Electronic Engineers (United States) of its members, the majority of the respondents favored expanded IRA provisions. In one day, through an 1-800 number sponsored by USA Today and manned by the International Association for Financial Planning, a member of the Savings Coalition, 73,000 phone calls were made requesting help with retirement planning. This is from a total circulation of 2 million. These results reveal that Americans are very concerned about their retirement. Provisions in H.R. 446 give them the incentive to help themselves.

By making the IRA available to all income levels, H.R. 446, The Savings and Investment Incentive Act of 1997, encourages all Americans to save. For those who claim that the benefits of expanded IRAs should be directed to Americans at certain income levels, the members of the Savings Coalition would like to point out that (1) the saving rate in this country is low and all Americans should be provided with incentives to save, and (2) the IRA contribution is limited to \$2000. The tax benefits from this \$2000 cap may not mean much to a high-income person—it is a small tax break for them. However, the benefits for everyone else that flow from universal availability (and the resultant advertising) will more than offset the small tax break for higher income individuals. Increasing the eligibility of IRAs for Americans is a good public policy that is popular with the American people, Congress and the White House.

***SAVINGS COALITION OF AMERICA
MEMBER ORGANIZATIONS***

A.G. Edwards, Inc.	American Association of Engineering Societies
American Bankers Association	American Council for Capital Formation
American Council on Education	American Express Financial Advisors
Association of Jesuit Colleges and Universities	American Nurses Association
Americans for Tax Reform	America's Community Bankers
Bank of America	Bankers Pension Services
The Bankers Roundtable	Chase Manhattan Bank
The Charles Schwab Corporation	Citicorp/Citibank
Citizens for a Sound Economy	College Savings Bank
Consumer Bankers Association	Countrywide Credit Industry
Credit Union National Association	Dean Witter, Discover & Co.
Delaware Charter Guarantee & Trust Company	Edward D. Jones & Company
Fidelity Investments	Financial Network Investment Corporation
First Trust Corporation	G. E. Capital
Gold & Silver Institutes	HD Vest Financial Services
Household International	Independent Bankers Association of America
Independent Insurance Agents of America	Institute for Research on the Economics of Taxation
Institute of Electrical & Electronics Engineers - United States Activities	
International Association for Financial Planning	Investment Company Institute
Kemper Corporation	Lincoln Trust Company
Merrill Lynch & Company, Inc.	Mortgage Bankers Association of America
NASDAQ Stock Market	National Association for the Self-Employed
National Association of Enrolled Agents	National Association of Federal Credit Unions
National Association of Home Builders	Home Savings of America
National Association of Independent Colleges and Universities	
National Association of Realtors	National Association of Uniformed Services
National Rural Electric Cooperative Association	Principal Financial Group
Prudential Securities, Inc.	Resources Trust Company
Retirement Industry Trust Association	Retirement Accounts, Inc.
Savers & Investors League	Securities Industry Association
Smith Barney	Sterling Trust Company
Transcorp Pension	United States Chamber of Commerce
Wheat First Butcher Singer	

Chairman ARCHER. Thank you, Mr. Thayer.

Our next witness is James Higgins. If you will identify yourself for the record, we would be pleased to receive your testimony.

STATEMENT OF JAMES F. HIGGINS, PRESIDENT AND CHIEF OPERATING OFFICER, DEAN WITTER FINANCIAL, NEW YORK, NEW YORK; AND CHAIRMAN, BOARD OF DIRECTORS, SECURITIES INDUSTRY ASSOCIATION

Mr. HIGGINS. Thank you, Mr. Chairman.

I am Jim Higgins, president and chief operating officer of Dean Witter Financial, a unit of Dean Witter Discover Card. Mr. Chairman, thank you for inviting me here to testify today on the savings and investment provisions in President Clinton's 1998 budget.

I am testifying before you today in my capacity as chairman of the board of directors of the Securities Industry Association.

Before I summarize SIA's position, I respectfully ask that you include my full written statement, along with a copy of an SIA-sponsored study on IRAs in the record of this hearing.

Chairman ARCHER. That will occur.

Mr. HIGGINS. Thank you.

Mr. Chairman, SIA commends you for holding this hearing. The securities industry shares your commitment for a balanced budget, sooner rather than later. We believe there is room in a balanced budget, however, for incentives to help all Americans save and invest for retirement security.

Congress will consider few issues that are more important than helping Americans repair for their retirements, especially when you consider the following. The U.S. savings rate is at an all time low. There are legitimate questions about Social Security and employer sponsored pension plans as the primary source of retirement income in the not too distant future. The baby boom generation is not saving enough for a secure retirement, even though the oldest among them will turn 65 in just 15 years. The next generation of retirees will spend as many years in retirement as they did working.

In light of these trends, Congress has a tremendous opportunity to make a difference in every American's life by giving them tools they can use to save enough to retire without worry. IRAs are a savings incentive with a proven record of success.

Mr. Chairman, I have spent my entire year, more than 25 years, at Dean Witter. My firm's client base is primarily individual investors, the people who stand to benefit the most from an enhanced IRA.

I served as a branch office manager during the eighties and can attest firsthand to the popularity of IRAs among our clients. According to industry statistics, one in six families, many with incomes under \$50,000, contributed annually to IRAs when they were widely available. IRAs worked because they were simple. Anyone could make a tax deductible contribution up to \$2,000 into an account that grew tax free until retirement.

In 1986 the Tax Reform Act transformed IRAs from a simple, easy-to-understand investment to a more complex, less accessible account. IRAs are not an attractive investment option for many individuals because they have very low income caps for deductible contributions. Eligibility is tied to an individual or their spouses

belongs to another plan, and there are high penalties for withdrawals, for whatever reason. Research shows, however, that people would contribute to an IRA if they were widely available again.

In a survey of Dean Witter clients, we found that nearly two-thirds are worried about their household's future financial condition and whether they will outlive their retirement savings. A large number of our clients have IRAs and many of them still make contributions. But among those who no longer do so, the overwhelming majority cited either the lack of tax advantage or participation in other 401(k) type plans as their primary reasons for stopping. When asked what would make them start again, two-thirds answered "restoring universal availability on a fully tax deductible IRA, regardless of income."

Recent experience has shown that our clients respond to positive changes in IRA. Last year, after Congress increased the amount, a nonworking spouse could contribute to the full \$2,000. The industry has experienced a notable increase in new IRA applications. We thank you for making this positive change in the law. SIA encourages you to build on this accomplishment with further enhancements to IRAs this year.

We are encouraged that the President included an expanded IRA in his budget. His proposal addresses some of the shortcomings of the current law by raising the income cap, indexing the contribution limit to inflation, and creating a flexible back-end IRA account. In our opinion, his proposal falls short of restoring the IRA to a simple, universally acceptable investment option. In addition, with its 5-year sunset, it cannot possibly stimulate enough savings to provide Americans with a secure retirement.

Instead, Mr. Chairman, SIA is pleased to support the Thomas-Neal Super IRA Proposal. It brings the universal availability, fully deductible IRA "out of retirement."

The Super IRA will do a number of things. It will restore simplicity to the process. It will take inflation into account by indexing the \$2,000 annual contribution. It will add flexibility by creating a back-end IRA that allows savers to make nondeductible contributions up front in exchange for tax-free withdrawals after retirement.

It will also appeal to younger people that will benefit by being allowed withdrawals for major life events, like buying a new home and college tuition.

SIA commends the sponsors, Mr. Thomas and Mr. Neal, for their leadership. The bill has broad bipartisan support, with over 100 cosponsors. The Super IRA is the type of savings incentive that Americans want and need.

In conclusion, Mr. Chairman, I want to thank you for holding this hearing and calling attention to the importance of savings and investment as an integral part of the balanced budget process.

I appreciate the opportunity to share SIA's views with you. We stand ready to work with you to restore the IRA as an investment option for all Americans, and I would be happy to answer questions you may have.

[The prepared statement follows. The article, "Journal of Economic Perspectives," is being retained in the Committee files.]

Statement of James F. Higgins, President and Chief Operating Officer, Dean Witter Financial; and Chairman, Board of Directors, Securities Industry Association

Chairman Archer, Mr. Rangel, members of the Committee, good morning. I am James Higgins, Chairman of the Board of Directors of the Securities Industry Association,¹ and President and Chief Operating Officer of Dean Witter Financial, a business unit of Dean Witter, Discover; Co. Thank you for inviting me here today to talk about the savings and investment incentives in President Clinton's fiscal 1998 budget. SIA commends you for holding this hearing. Congress will consider few issues of greater importance than helping Americans save for a secure retirement.

We are not saving enough to remain globally competitive in the long-term as a nation or financially secure as individuals. The Clinton Administration's budget contains proposals to encourage savings and investment through improved Individual Retirement Accounts (IRAs) and narrowly targeted capital gains tax cuts. SIA believes the Administration is on the right track with these proposals, but ultimately that they will not encourage the levels of savings and investment needed for national economic growth and personal retirement income security.

Mr. Chairman, your colleagues on the Committee have introduced legislation, H.R. 446, that would help all Americans save for retirement. SIA commends the sponsors—Mr. Thomas and Mr. Neal—for their leadership. Similarly, we salute Representative English, who, together with Representatives Dreier, Hall, Moran and McCarthy, introduced H.R. 14—a broad-based capital gains tax cut that treats all assets equally. Both bills have attracted bipartisan support, with many cosponsors lined up across both sides of the aisle. SIA fully supports these measures and urges Congress to enact them as part of an overall plan to balance the budget by 2002.

THE U.S. SAVINGS CRISIS

The United States faces a saving crisis. Americans today are saving less than at almost any time since World War II. The personal savings rate has plummeted from 8 percent of disposable income in 1970 to only about 4.9 percent in 1996. In fact, American households currently save less than half as much as those in Britain and Germany and a third as much as those in Japan and France.

This drop in personal savings has driven the decline in U.S. national savings (defined as the sum of all savings by households, businesses, and government), a fact some have failed to recognize. Many policy makers believe that the fall in national savings can be attributed to federal budget deficits. To the contrary, statistics reveal that the fall in personal savings has been a larger contributor to the drop in national savings during the last 25 years than has been the increase in the budget deficit. Net national savings fell from an average of 8.5 percent of net national product during the 1970s to 4.7 percent during the 1980s, and to only 2.4 percent so far during the 1990s.²

The overall economy and individual Americans alike are being hurt by this drop-off in savings. At the national level, the savings crisis saps the fuel for long-term growth, because domestic savings is a vital source of capital for domestic investment. In today's economy, the fall in personal savings from 8 percent to 4 percent represents a loss of roughly \$200 billion of capital that could have been put to work in the U.S. economy. The cost of losing this capital is evident in the steady declines of U.S. domestic investment. While domestic investment averaged about 8 percent of NNP from the 1950s through the 1970s, it fell to 6.1 percent in the 1980s and has fallen further to just 3.1 percent so far in the 1990s. By limiting investment in the American economy, the saving crisis slows business growth and keeps living standards from rising.

The impact of the savings crisis is personal, as well as national. As SIA member firms witness every day in our dealings with clients across the U.S., low savings has direct and serious implications for individual families. Simply stated, Americans are not saving enough for a secure retirement. A recent study of household finances

¹The Securities Industry Association brings together the shared interests of more than 760 securities firms throughout North America to accomplish common goals. SIA members—including investment banks, broker-dealers, specialists, and mutual fund companies—are active in all markets and in all phases of corporate and public finance. In the U.S., SIA members collectively account for approximately 90 percent, or \$100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. (More information about SIA is available on its home page: <http://www.sia.com>.)

²Economic Report of the President. U.S. Department of Commerce.

found that half of all American households has less than \$1,000 in net financial assets.³ Current trends indicate the likelihood that in the next century, many Americans will spend as much time in retirement as they did working. Moreover, the amount of retirement income considered adequate is increasing because of early retirements, longer life expectancies, and escalating health care costs. These concerns are even more pronounced when you consider that the first of the 76 million baby boomers will reach retirement age in just 15 years. Research shows that this generation is woefully unprepared for the future—on average, they are saving at about one-third the rate necessary to maintain a comfortable standard of living in retirement.⁴

At the same time, fewer Americans believe they can depend on the government or their employer as their primary source of retirement income. The Nasdaq Stock Market, in a recent investor survey, found that 41 percent of investors believe that most of the money for their retirement will come from personal savings and investment. In contrast, only 25 percent are relying on a retirement plan, and just 4 percent on Social Security to make up the bulk of their retirement income.⁵ This is a remarkable shift in attitude—when SIA testified on these issues in 1993, only 11 percent of Americans believed personal savings would be their prime source of retirement income.

For our part, SIA has taken the initiative to educate Americans about the importance of savings and investment. We developed two publications to help people make sense of available investment options. The first—*Investor Topics*—is a pamphlet that answers the basic questions people have when they start investing. The second—*Your Guide to Understanding Investment*—is a comprehensive and accessible guide that walks the reader through the risks and rewards of investing. We have also worked with the Securities and Exchange Commission in their well-received series of investor town meetings across the country.

SOLVING THE SAVINGS CRISIS

Mr. Chairman, SIA believes America's economic future hinges in large part on solving the savings crisis. Increased savings is vital both to prepare the overall economy for strong growth into the next century and to provide American households with greater financial security today and into retirement. Expanding IRAs would be a giant step toward reviving America's savings habit. Congress started down this road last year, with passage of the "spousal IRA," which increases the amount a non-working spouse can contribute to an IRA to \$2,000. SIA commends you for making this enhancement to the law. Already, it is making an impact—the industry is seeing a significant upswing in IRA applications since the law was signed last October.⁶ This shows that Americans do respond to improvements in IRAs. SIA urges you to build on what you started and further expand and simplify IRAs for all Americans.

IRAS WORK

The restriction of IRAs played an important role in the decline of U.S. savings. Indeed, the drop in annual IRA savings is equal to about 40 percent of the decline in annual personal savings since 1986. Annual IRA contributions peaked in 1985, at just over \$38 billion. They have fallen every year since, reaching a level of just \$8 billion in 1993.⁷ If the IRA had not been curtailed by the Tax Reform Act of 1986, we conservatively estimate that the total pool of IRA assets would be \$400 billion larger than it is today. SIA believes that a revitalized IRA will be popular

³ Anderson, Joseph M. *The Wealth of American Families in 1991 and 1993*. Capital Research Associates, December 1994. The study also found that even older families, headed by individuals ages 45 to 54, had only \$2,600 in median net financial assets.

⁴ Bernheim, Douglas B. *The Merrill Lynch Baby Boom Retirement Index*. Merrill Lynch, 1994. Dr. Bernheim compared the rate the Baby Boomers are actually saving with what they should be saving in order to retire at age 65 with the same standard of living they enjoyed during their pre-retirement years. An Index of 100 percent would mean that Baby Boomers are saving at the rate needed to retire at a consistent standard of living. Dr. Bernheim's calculations place the Index at 35.9 percent, a little more than one-third the minimum rate.

⁵ Peter D. Hart Research Associates, *A National Survey Among Stock Investors: Conducted for The Nasdaq Stock Market*. February 1997.

⁶ SIA is currently surveying its membership to determine the full effect of the spousal IRA provisions on the market. Results of this survey will be available later this year.

⁷ Hubbard, R. Glenn and Jonathan Skinner. *The Effectiveness of Savings Incentives: A Review of the Evidence*. Paper sponsored by the Faculty Research Fund of the Graduate School of Business of Columbia University and the Securities Industry Association. January 1995.

with the American people, will lift the personal and national savings rates, and will provide an important middle class tax cut.

Popular Support. IRAs enjoy exceptional public support. In fact, a survey conducted shortly after the 1994 Congressional election found that IRAs were the single most popular tax proposal included in the Republican Contract With America that year.⁸ Despite the strong support for IRAs in Congress and by the Administration, Americans do not believe Washington is helping them save for retirement. Fully 70 percent of baby boomers disagree with the statement, "The government encourages me to save."⁹ Market research conducted by Opinion Research on behalf of Dean Witter supports this point. We found that nearly two-thirds of our clients said they would put money into an IRA if their contributions were tax deductible.

New Savings. Furthermore, IRAs represent new savings, and are not simply assets shifted from one account to another. Professors Glenn Hubbard of Columbia University and Jonathan Skinner of the University of Virginia performed an extensive analysis of the research on IRAs and savings patterns. They concluded that a "conservative estimate of the effect of IRAs on personal saving would be about 26 cents per dollar of IRA contribution."¹⁰

Cornell University economist Richard Thaler contends it doesn't matter if money is shifted into an IRA from other savings because the withdrawal penalties make it much more likely that savings in an IRA will accumulate over time. "Money in a savings account can be splurged on a new car, but money in an IRA is likely to stay put," Dr. Thaler observed.¹¹ IRAs will increase long-term savings because they get money into an account where funds cannot be quickly spent, even if the funds would have been saved anyway in another type of savings account.

Benefit the Middle Class. Improved IRAs will benefit the middle class. From 1982–1986, IRAs were overwhelmingly used by middle-income Americans. At the peak of the IRA's popularity in 1985 and 1986, 75 percent of IRA contributions were made by Americans with incomes under \$50,000. The IRA income limits established in 1986 were not indexed for inflation, which is why IRA eligibility continues to decline sharply. Among workers whose spouses also work, 53 percent were eligible for a full IRA deduction in 1987. This fell to 45 percent in 1991 and only 38 percent in 1995.¹²

The Tax Reform Act of 1986 transformed IRAs from a simple investment option into a more complex product with many eligibility requirements which limits its attractiveness. When the eligibility requirements were tightened and the accounts became more complex, financial institutions curtailed their advertising. This is an important point, because advertising contributed significantly to the widespread popularity of IRAs during the early 1980s. A simple, universally available IRA would undoubtedly encourage financial institutions to run advertisements encouraging savings. This, in turn, will succeed in getting many clients who used to contribute to IRAs back in to the "saving habit," as well as lead many new savers to open IRA accounts. Indeed, Deputy Treasury Secretary Lawrence Summers said such an increase in advertising "could encourage families to focus their energies on developing a savings plan, even if they do not open IRAs."¹³

You only need to look as far as Canada to see how significant a change in the advertising message can be. Walk down a city street, and you will see financial institutions advertising the opportunity to save in a Canadian tax-preferred account. Contrast that message of savings with the U.S., however, where our financial services firms most often promote more and better ways to borrow. The difference is striking, and borne out in the fact that the household saving rate in Canada is more than twice that of the United States. By restoring the fully deductible IRA, Congress can literally change the advertising message reaching the passer-by on countless streets across America. The promotional efforts surrounding an improved IRA would reemphasize the importance of savings to U.S. consumers.

⁸The Luntz Research Companies. February Omnibus Survey II: Budget, Superfund, Medicare; Defense. February 22–23, 1995.

⁹Engin, Eric M., William G. Gale, and John Karl Scholz. Do Savings Incentives Work? Brookings Papers on Economic Activity. 1:1994.

¹⁰Hubbard and Skinner. Op. cit.

¹¹Thaler, Richard H. Psychology and Savings Policies. AEA Papers and Proceedings. May 1994. Page 186.

¹²Employee Benefit Research Institute. Individual Saving for Retirement. EBRI Fact Sheet. September 1995.

¹³Testimony of Lawrence H. Summers, Deputy Secretary of the Treasury, before the Senate Committee on Finance. March 6, 1997.

SIA SUPPORTS THE SUPER IRA

SIA believes IRAs must be universally available, simple to understand, must not penalize individuals who participate in other retirement plans, and must not tie non-wage-earning spouses' eligibility to whether their spouse has a pension plan. The Administration's proposal is a good start toward improving IRAs, but falls short of the mark on each of these principles. The Administration doubles the current income caps for deductible contributions to \$50,000 for individuals and \$80,000 for couples. Although this is an improvement over current limits, it is still not high enough to capture many middle income families with two wage-earners.

The biggest problem with the Administration's IRA, however, is its five-year sunset. Americans need a permanent solution to the savings crisis—five years is not long enough to accumulate sufficient savings for a comfortable retirement. In fact, taxpayers who open a back-end IRAs under the President's proposal would never get to take advantage of its key feature—tax deductible withdrawals after retirement—unless they were at least 55 when they opened the account.

SIA believes Representatives Thomas' and Neal's "Super IRA" proposal contained in H.R. 446 achieves our goals. Unlike the President's plan, anyone—regardless of income or pension plan or marital status—may make an annual \$2,000 tax-deductible contribution to an IRA. This contribution limit is indexed to inflation.

The Thomas-Neal Super IRA proposal also creates a new kind of IRA with a "back end" tax incentive. This feature would allow savers to make deposits to the account from after-tax dollars, while qualified withdrawals would be tax free. Although "back-end" savings incentives and traditional "front-end" savings incentives are economically equivalent, we believe the back-end account can offer important new flexibility to Americans. We are pleased H.R. 446 gives Americans the option to choose the type of account that best suits their needs.

Furthermore, the expanded withdrawal features of the Super IRA may attract savers who might not otherwise contribute to an IRA. In particular, these features will appeal to younger savers who—in addition to retirement—need a vehicle to save for major expenses, such as a down payment on a first home or college tuition.

Mr. Chairman, a revitalized IRA would create a vast pool of new savings in the American economy. We believe that contributions to a new and popular IRA program could accumulate to more than \$1 trillion in the first 10 years of the program. These funds would represent not only \$1 trillion in capital for new investment by U.S. business, but also a \$1 trillion nest egg for American families. The federal budget would be a huge beneficiary of increased savings, as the accumulation of savings could lead to lower interest rates in the long run. According to the Congressional Budget Office, every 50-basis-point drop in interest rates would save the government more than \$25 billion annually in lower interest payments on outstanding government debt alone.

REDUCING THE TAX CODE'S BIAS AGAINST INVESTMENT

The present tax system contributes to the savings crisis. With few exceptions, taxes are imposed twice—first when salary and wage income are earned, and again, when interest and dividends on the investment financed by savings are received. Corporate profits are taxed first at the corporate level, and again after they are distributed to shareholders as dividends. Capital gains are also singled out for harsh treatment—all taxpayers except those in the highest tax brackets pay the same rate for capital gains as ordinary income; inflationary gains are subject to taxation; and though taxpayers must pay taxes on all gains, they are allowed to deduct only \$3,000 in capital losses annually. The individual or company that saves and invests pays more taxes over time than if all money were spent on consumption and no saving took place.

In addition, the U.S. taxes capital gains more harshly than almost any other industrialized nation. An OECD survey of 12 industrialized countries found that the U.S.'s capital gains tax rate on long-term gains on securities is higher than all countries except Australia and the U.K. Those countries, however, index the cost basis of the asset. The countries surveyed also treat corporate capital gains more favorably than the U.S. Not surprisingly, most of these countries have higher national and personal savings and investment rates than the U.S.¹⁴

Lower Cost of Capital. Taxes on income from investment raise the cost of capital of new, productive investment for both individuals and corporations. Studies show

¹⁴Organization for Economic Cooperation and Development. OECD Economic Outlook 57, June 1995, Annex Table 26, page A-29. Countries in the OECD survey included the U.S., Japan, Australia, Belgium, Canada, France, Germany, Hong Kong, Italy, the Netherlands, Sweden, and the United Kingdom.

that the user cost of capital for most types of productive equipment would be 15 percent lower if the Tax Reform Act of 1986 had not been enacted. Moreover, a capital gains tax rate in the range of 15 to 20 percent would reduce the cost of capital by 4 to 8 percent. Lowering the cost of capital will encourage businesses to make the kinds of investment in plant and equipment, research and development, and new technologies that increase productivity and create new jobs.

Encourage Small Business and Entrepreneurs. A lower cost of capital is especially important for small businesses. According to the U.S. Small Business Administration, small businesses employ 53 percent of the private work force in the U.S., contribute 47 percent of all sales in the country, and are responsible for 50 percent of the gross domestic product. Of the 3.3 million new jobs created in 1994, an estimated 62 percent were produced by small businesses. Clearly, this is a growing sector of the economy—indeed, the number of small businesses has increased by almost 50 percent since 1982, with 800,000 new businesses incorporated in 1995 alone.

Many small businesses are newer, riskier enterprises that do not have the same financing options or flexibility as Fortune 500 companies. Much of the start-up money comes from investors, venture capital pools, family members, and acquaintances. Because these investors' return is in appreciated stock, lower capital gains taxes will make people more willing to risk their savings on new ventures. High capital gains taxes, on the other hand, frustrate would-be entrepreneurs and reduce the rate of return for investors.

Benefit All Investors. Capital gains tax cuts would benefit all investors. Individuals are investing in the capital markets as never before. More than one-third of all adult Americans owns stock either directly or indirectly through a mutual fund, corporate savings program, or a defined retirement contribution plan. Investors now have more of their liquid financial assets in capital market investments than in bank accounts. This cuts across all income levels—IRS statistics show that more than half of all returns reporting capital gains are from households with incomes below \$50,000. These statistics are not surprising when you consider that 60 percent of households in this income range own mutual funds.

Increased Revenue. Not only will lower capital gains taxes encourage savings, investment, and entrepreneurship, they will also bring in more revenue for the government in the long run. There is an abundance of anecdotal evidence of investors who hold on to assets that they would otherwise sell simply to avoid paying capital gains taxes. Lower rates would “unlock” this capital by giving investors incentive to sell these assets.

Beyond the anecdotes, however, every time Congress lowered capital gains tax rates in the past, the Treasury saw an increase in revenues. For example, from the years 1978 to 1985, the marginal federal tax rate on capital gains was cut from almost 50 percent to 20 percent. At the same time, total individual capital gains tax receipts increased from \$9.1 billion to \$26.5 billion. Revenue estimates do not fully consider the unlocking effect or other positive macroeconomic effects (i.e., lower cost of capital, greater productivity, increased jobs, stronger economy) when predicting that lower capital gains taxes will be a money loser for the Treasury.

SIA SUPPORTS BROAD-BASED CAPITAL GAINS TAX CUTS

SIA supports a broad-based capital gains tax cut that treats all investors and assets equally. The President's proposal, however, only allows individuals to exclude up to \$250,000 profit from the sale of their home from capital gains taxes. The amount of the exclusion rises to \$500,000 for couples. We believe this provision is far too narrow to produce the considerable economic benefits that will result from a broad-based cut. In addition, the President's budget includes two proposals that will raise the effective tax rates on securities transactions. SIA is opposed to the average cost basis and short against the box proposals, and believes they should be deleted from the budget at the outset.¹⁵

Other proposals have been introduced in Congress to target certain investments for favorable capital gains treatment or to compute the rate on a sliding scale based on how long the investor has held the asset. While both of these types of proposals have some merit, SIA believes they do not go far enough. The sliding scale approach would counteract some of the effects of inflation and reward long-term investors. These benefits, however, will be far outweighed by the complexity and administrative burdens of different rates. In addition, tying the tax rate to the length of time

¹⁵SIA appeared before the Ways and Means Committee on March 12, 1997, to discuss its views on the revenue raising provisions in the President's budget. SIA's testimony for that hearing sets out in detail its opposition to 14 tax proposals in the budget, including average cost basis and short against the box.

an asset is held draws arbitrary lines that will distort investment decisions as much as the current high rate.

Targeted tax cuts also draw arbitrary lines. Though we understand the policy behind encouraging investments in small business, venture capital, real estate, enterprise zones, and farms, targeted cuts will not produce the same impact on the economy as a broad-based cut. They are also unfair to holders of ineligible assets. In recent testimony before the Senate Finance Committee, former Federal Reserve Board Chairman Paul Volcker said, "The trouble is targeted reductions require rather arbitrary distinctions, add greatly to administrative complexity, and generate essentially unproductive efforts to artificially meet the favored tax criteria."¹⁶

Legislation has been introduced in Congress, however, that meets our objectives for a capital gains tax cut. H.R. 14, introduced by Representative Dreier, together with Mr. English, Mr. Moran, Mrs. McCarthy, and Mr. Hall, provides for an across the board 50-percent exclusion for capital gains on assets held longer than a year. Under their proposal, the top individual capital gains rate would be reduced to 14 percent, while the rate would fall to 7.5 percent for taxpayers in the lowest tax bracket.

The broad-based cuts in H.R. 14 make good economic sense—they will lower the cost of capital and help reduce the tax code's bias against savings and investment. Broad-based cuts are also fair to all income groups and all sectors of the economy. And finally, SIA believes H.R. 14 will be at least revenue neutral. As investors "unlock" existing capital gains, they will make the types of investment that expand businesses, create jobs, and spur economic growth.

CONCLUSION

In conclusion, Mr. Chairman, SIA commends you once again for your emphasis on savings and investment in the context of a balanced budget. Thank you for allowing me to share the securities industry's views on these vitally important subjects. Expanded IRAs and broad-based tax capital gains tax cuts will go a long way toward increasing the savings rate in the U.S., encouraging Americans to save for their retirements, and expanding the economy. SIA looks forward to working with you as you consider the role savings and investment incentives will play in the debate.

Chairman ARCHER. Thank you, Mr. Higgins.

Our next witness is Dr. Paul Yakoboski. Did I get that pronunciation pretty close?

Mr. YAKOBOSKI. Yes, you did.

Chairman ARCHER. We are happy to have you before the Committee, and if you will identify yourself for the record, we will be pleased to receive your testimony.

STATEMENT OF PAUL J. YAKOBOSKI, PH.D., SENIOR RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Mr. YAKOBOSKI. Thank you, Mr. Chairman.

My name is Paul Yakoboski. I am a senior research associate at the Employee Benefit Research Institute, a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed since its founding in 1978 to the accurate statistical analysis of economic security issues. Through our research, we strive to contribute to the formulation of effective and responsible health and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

¹⁶Statement of Paul A. Volcker before the Senate Committee on Finance. March 13, 1997.

I am pleased to appear before you this afternoon to discuss issues of individual retirement accounts and alternative tax-qualified retirement savings plans.

The original objective in establishing IRAs was to provide a tax-deferred retirement savings vehicle for those workers who did not have an employment-based retirement plan. However, the fact is that the vast majority of workers eligible for a tax-deductible IRA contribution do not contribute.

According to our tabulations of 1993 current population survey data, the latest data available, 89 percent of single workers are eligible for a deductible IRA contribution, but only 5 percent of these contribute. Fifty-six percent of dual-income couples are eligible for a deductible IRA contribution, but only 10 percent of these contribute. Seventy-two percent of single-income couples are eligible for a deductible IRA contribution, but only 9 percent of these contribute. Participation rates are higher for those with greater incomes, but still, the highest participation rate is 27 percent among single workers with annual incomes of \$50,000 or more.

Alternatives to IRAs exist that allow workers to save money for retirement on the same tax-deferred basis enjoyed by fully deductible IRA contributions. Such plans include the Federal thrift savings plan, private sector 401(k) plans, SIMPLE plans for small employers, public sector 457 plans, and 403(b) plans for certain charitable organizations, public school and university systems. These plans, referred to here as salary reduction plans, are the employment-based, tax-qualified plans offered at an employer's discretion and, therefore, are not available to all workers.

Differences between IRAs and salary reduction plans include the amount that can be contributed on a tax-deductible basis, which is typically much higher through a salary reduction plan than with an IRA. Salary reduction contributions may, however, be limited by nondiscrimination standards, while IRAs are not subject to such standards.

Some salary reduction plans allow loans to participants, while IRAs are prohibited from offering loan features. IRA money can be withdrawn at any time for any purpose, but it is typically subject to a 10-percent penalty tax, in addition to income taxation if withdrawn before age 59½.

Penalty-free IRA withdrawals can now be made to pay medical expenses that exceed 7.5 percent of a taxpayer's adjusted gross income. If a salary reduction plan does not allow loans or withdrawals, a worker cannot access funds in his account until he leaves that employer.

Salary reduction plans continue to grow as an important element of the employment-based retirement income system. According to our tabulations of the 1993 CPS, 65 percent of workers with an employer who sponsors such a plan choose to contribute, and this figure is up from 55 percent 5 years earlier.

Why are participation rates among eligibles so much higher for employment-based salary reduction plans than with IRAs? A likely reason is that participation in a salary reduction plan is generally more convenient. Since it is offered through the workplace, it involves automatic contribution deductions from a worker's paycheck.

Also, plan sponsors typically market the plan to their employees and educate them as to the importance of saving for their retirement income security through the plans. Employer-matching contributions are also available in many salary reduction arrangements.

Finally, it is possible that some workers who are eligible for a tax-deductible IRA contribution may not be aware of their eligibility or they may not appreciate the inherent tax advantages offered by an IRA.

Thank you.

[The prepared statement and attachments follow:]

**Statement of Paul J. Yakoboski, Ph.D., Senior Research Associate,
Employee Benefit Research Institute**

I am pleased to appear before you this morning to discuss issues of individual retirement accounts (IRAs) and alternative tax-qualified retirement saving plans. My name is Paul Yakoboski. I am a senior research associate at the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

IRA USAGE

Through enactment of the Employee Retirement Income Security Act of 1974 (ERISA), Congress established IRAs to provide workers who did not participate in employment-based retirement plans an opportunity to save for retirement on a tax-deferred basis. U.S. tax law has substantially changed the eligibility and deduction rules for IRAs since then. The Economic Recovery Tax Act of 1981 (ERTA) extended the availability of IRAs to all workers, including those with pension coverage. The Tax Reform Act of 1986 (TRA '86) retained tax-deductible IRAs for those who did not participate in an employment-based retirement plan (and if married, whose spouse did not participate in such a plan), but restricted the tax deduction among those with a retirement plan to individuals with incomes below specified levels. In addition, TRA '86 added two new categories of IRA contributions: nondeductible contributions, which accumulate tax free until distributed, and partially deductible contributions, which are deductible up to a maximum amount less than the \$2,000 maximum otherwise allowable. The Small Business Job Protection Act of 1996 increased the amount that may be contributed on a deductible basis on behalf of a nonworking spouse (if the working spouse is eligible for a deductible contribution) from \$250 to \$2,000.¹

The overwhelming majority of those workers eligible to make a tax-deductible contribution to an IRA currently choose *not* to do so. This is true among single workers

¹Under current law, individuals who are not active participants (and, if married, whose spouse is not an active participant) in a qualified employment-based retirement plan can make fully tax-deductible contributions up to a \$2,000 maximum per year to an individual retirement account (IRA). Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose adjusted gross income (AGI) does not exceed \$25,000 (single taxpayers) or \$40,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI falls between \$25,000 and \$35,000 (single taxpayers) and between \$40,000 and \$50,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution of less than \$2,000 and a nondeductible IRA contribution for the balance, as follows. The \$2,000 maximum deductible contribution is reduced by \$1 for each \$5 of income between the AGI limits. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI is at least \$35,000 (single taxpayers) or at least \$50,000 (married taxpayers filing jointly) may only make nondeductible IRA contributions of up to \$2,000; earnings on the nondeductible contribution are tax deferred until distributed to the IRA holder. The Small Business Job Protection Act of 1996 increased the amount that may be contributed on a deductible basis on behalf of a nonworking spouse (if the working spouse is eligible for a deductible contribution) from \$250 to \$2,000. Thus a single earner couple, if eligible for a fully deductible IRA contribution, may contribute \$4,000. IRAs can also be established as rollover vehicles for lump-sum distributions from employment-based retirement plans or other IRAs.

and among married couples (both one earner and two earner couples). And it is true across income groups, although those with higher incomes are more likely to contribute when eligible (table 1).

According to EBRI tabulations of the April 1993 Current Population Survey employee benefits supplement (CPS-eps), in 1992, 89 percent of all single workers were eligible to make an IRA contribution that was at least partially tax deductible. All such workers earning less than \$35,000 (86 percent of single workers) were eligible. In addition, 22 percent of single workers earning between \$35,000 and \$49,999 and 20 percent of those earning \$50,000 or more were eligible for a deductible IRA contribution.

Among single workers, only 5 percent of those eligible for a deductible IRA contribution actually contributed to an IRA in 1992. The likelihood of making a contribution increased with worker earnings. Only 1 percent of those eligibles making less than \$10,000 contributed, compared with 27 percent of those making \$50,000 or more.

Fifty-six percent of married couples with both spouses working were eligible to make an IRA contribution that was at least partially tax deductible. All such couples with combined incomes of less than \$50,000 were eligible, and 10 percent of those with combined incomes greater than \$50,000 were eligible. Among eligible two earner couples, 10 percent made an IRA contribution in 1992. Among eligible two earner couples, the likelihood of making a contribution increased with the couples' income. Among couples with a combined income of less than \$10,000, essentially none contributed, while 23 percent of couples making \$50,000 or more made an IRA contribution.

Married couples with one earner are more likely than those with two earners to be eligible for a deductible IRA contribution. Seventy-two percent of single earner couples were eligible to make an IRA contribution that was at least partially tax deductible. This included 100 percent of those earning less than \$35,000, 22 percent of those earning \$35,000 to \$49,999 and 16 percent of those earning \$50,000 or more. Among eligible single earner couples, 9 percent made an IRA contribution in 1992. Six percent of those making less than \$10,000 made a contribution, compared with 22 percent of those making \$50,000 or more.

While IRAs were created to allow individuals without an employment-based retirement plan to save for retirement on a tax-deferred basis, the fact is that the vast majority of those eligible to make tax-deductible contributions to an IRA choose not to do so. It is often speculated that this is due to a lack of money, but even among higher earning workers, those who are eligible for a deductible IRA still do not, in general, participate. It is also often speculated that individuals are reluctant to tie up their savings in a vehicle where it is beyond their reach, without significant tax penalties, should they need the money before retirement.²

SALARY REDUCTION PLANS

Alternatives to IRAs exist that allow workers to save money for retirement on the same tax-deferred basis enjoyed by fully deductible IRA contributions. These plans, referred to here as salary reduction plans, are offered through work at an employer's discretion, and therefore are not available to all workers. However, when they are available to workers, they do have some advantages relative to IRAs as a retirement wealth accumulation tool. These are discussed shortly.

Salary reduction plans include 401(k) plans, 457 plans, 403(b) plans, and the federal Thrift Savings Plan (TSP). The Revenue Act of 1978 permitted employers to establish 401(k) arrangements, named after the Internal Revenue Code (IRC) section authorizing them. In 1981, the Internal Revenue Service (IRS) issued the first set of proposed regulations covering such plans. These proposed regulations provided some interpretive guidelines for sec. 401(k) and specifically sanctioned "salary reduction" plans. Through 401(k) arrangements, participants may contribute a portion of compensation (otherwise payable in cash) to a tax-qualified employment-based plan. Typically, the contribution is made as a pretax reduction in (or deferral

²Distributions from IRAs are taxed as ordinary income in the year received, except for the portion of the total IRA distribution that is attributable to nondeductible contributions, which are excludable from gross income. Taxable distributions prior to age 59½ are subject to a 10 percent penalty tax, unless they are taken as part of a series of equal payments made for the life (or life expectancy) of the IRA owner and his or her beneficiary, or the IRA owner dies or becomes disabled.

of) salary that is paid into the plan by the employer on behalf of the employee.³ In many cases, an employer provides a matching contribution that is some portion of the amount contributed by the employee, generally up to a specified maximum. The employee pays no federal income tax on the contributions or on the investment earnings that accumulate until withdrawal. Some plans also permit employee after-tax contributions; the earnings on these contributions are also not taxed until withdrawal.

Public-sector employers can establish deferred compensation plans under IRC sec. 457; charitable organizations qualified under IRC sec. 501(c)(3) (for example, a tax-exempt hospital, church, school, or other such organization or foundation) and public school systems and public colleges and universities can establish tax-deferred annuity plans under IRC sec. 403(b). The 1983 Social Security Amendments required that a new civil service retirement system be established to cover federal employees hired after December 31, 1983. The Federal Employees Retirement System (FERS), which Congress adopted in 1986 and which went into effect in January 1987, combines Social Security, a defined benefit pension plan, and an optional tax-deferred thrift plan similar to a private-sector 401(k) arrangement. Employees hired before the end of 1983 were given the option of joining the new system or remaining in the old Civil Service Retirement System (CSRS) during a six-month period ending in December 1987.⁴

COMPARISON WITH IRAS

Salary reduction plans offer an advantage over IRAs in that the amount that can be contributed on a tax-deductible basis is much higher. The maximum deductible IRA contribution is \$2,000 annually, compared with \$9,500 for 401(k), 403(b) plans, and the federal TSP, and \$7,500 for 457 plans. Furthermore, the limits on the salary reduction plans are indexed for inflation, while the IRA maximum is not. However, nondiscrimination standards for salary reduction plans in the private sector may limit the amount that highly compensated employees⁵ can contribute. In some instances such highly compensated employees may not be allowed to contribute the dollar amount cited above, and in extreme cases they may not be allowed to contribute anything to the plan as a result. Since IRAs are not employment-based, they are not subject to such nondiscrimination standards.

Employers will often provide matching contributions on a certain percentage of the earnings that a worker chooses to contribute (e.g., an employer may match 50 percent of the first 6 percent of pay that participants in the plan choose to contribute). Such matching contributions are optional on the part of the employer, and thus do not constitute an inherent advantage for these plans over IRAs. They may, however, serve as a strong incentive to participate, as will be discussed later.

A second advantage of salary reduction plans over IRAs is that the plan sponsor serves as a fiduciary filter for the thousands of investment options available today. Salary reduction plans offer participants a limited menu of investment options from which to choose. The plan sponsor has a fiduciary duty to choose the options offered in a prudent manner. In essence, the sponsor has already done the first round of screening for the participant.

Sec. 401(k) and 403(b) plans can allow loans to participants. Whether a plan has a loan feature is at the discretion of the plan sponsor. The federal TSP does have a loan feature. Sec. 457 plans are not allowed to offer loans. IRAs do not have loan features. However, IRA money can be withdrawn at any time for any purpose (it is generally subject to a 10 percent penalty tax if withdrawn before age 59, in addition to income taxation). Salary reduction plans may allow withdrawals in instances of "hardship," but they are not required to do so. If a plan does not allow loans or hardship withdrawals, a worker would not be able to access the funds in his or her account under any circumstances until the time he or she leaves that employer.

³The Tax Reform Act of 1986 placed a \$7,000 limit on pretax employee contributions to private-sector 401(k) plans. This limit was indexed to the consumer price index beginning in 1988. The 1997 limit is \$9,500.

⁴The thrift plan is available to workers covered by either FERS or CSRS, but different rules apply to the two groups. FERS employees are automatically covered under the thrift plan, and the government contributes the equivalent of 1 percent of pay for each employee whether or not the individual contributes. Employees may make further contributions of up to 10 percent of base salary (up to the same dollar maximum as 401(k) plans). The government will then match, dollar for dollar, the first 3 percent of employee contributions and 50 percent of the next 2 percent, with no match beyond 5 percent. CSRS participants may contribute up to 5 percent of their salaries to the thrift plan but are not entitled to government contributions.

⁵See IRC sec. 414(q) for definition of highly compensated employee.

PARTICIPATION

Salary reduction plans continue to grow as an important element of the employment-based retirement income system. According to EBRI tabulations of the April 1993 CPS-ebs, the percentage of civilian nonagricultural wage and salary workers with an employer who sponsors a salary reduction plan (the sponsorship rate) increased from 27 percent (27 million workers) in 1988 to 37 percent (39 million workers) in 1993 (table 2). Over the same time period, the fraction of all workers participating in such plans (the participation rate) rose from 15 percent (16 million workers) to 24 percent (25 million workers). The fraction of participating workers among those where a salary reduction plan was sponsored (the sponsored participation rate) also increased, rising from 57 percent to 65 percent. The growth in salary reduction plan sponsorship and participation has occurred across almost all worker and job-related characteristics, including firm size.

The likelihood of salary reduction plan sponsorship and participation increased with firm size (table 2). In 1993, 5 percent of those employed by a firm with fewer than 10 employees reported that their employer sponsored a salary reduction plan, as compared with 54 percent of those employed by firms with 1,000 or more employees. When a plan was sponsored, the participation rate did not vary systematically with firm size. In all but the smallest employer category, the participation rate among workers where a plan was sponsored was about two-thirds. In the smallest firms (fewer than 10 employees), almost three-quarters of workers where a plan was sponsored chose to participate. Therefore, the positive relationship between firm size and overall participation rates was solely a function of the positive relationship between firm size and sponsorship rates.

The higher a worker's earnings, the more likely he or she was to have a plan available at work. Two-thirds of workers earning \$50,000 or more had an employer that sponsored a salary reduction plan, compared with only 8 percent of workers earning less than \$5,000 (table 2). Furthermore, when a plan was available, higher earning workers were more likely to participate than lower earners. Twenty percent of workers earning less than \$5,000 contributed to a plan when one was offered, compared with 83 percent of workers earning \$50,000 or more.

DISCUSSION

As seen above, participation rates among eligibles are much higher for employment-based salary reduction plans than for IRAs. Why?

Participation in a salary reduction plan is generally more convenient since it is offered through the workplace and involves automatic contributions from a worker's paycheck before he or she even sees the money. Plan sponsors will also market the plan to their employees and typically educate them as to the importance for their retirement income security of participating in the plan. With IRAs, on the other hand, an individual must make a conscious decision to seek out such information on his or her own (unless it is offered through work). Moreover, it has been speculated that some workers who are eligible for a tax-deductible IRA contribution may not be aware of their eligibility.

Another important reason is the availability of employer matching contributions with salary reduction plans. Among workers whose employer sponsored a salary reduction plan in 1993, 51.3 percent reported that their employer provided matching contributions to the plan. The actual percentage was likely higher because 30.2 percent did not know if their employer matched contributions. Among those responding that their employer did provide a matching contribution, the average reported match rate was 65 percent (i.e., for every \$1 the employee contributed, the employer contributed 65 cents). Such employer matching contributions are not available with IRAs.

Studies have found evidence that the availability of an employer match does have an effect on participation. For example, a 1995 Hewitt Associates' study of 401(k) plans found an average participation rate of 76 percent in plans with an employer match as opposed to an average of 59 percent in plans with no employer match.⁶ Similarly, a 1996 Buck Consultants study of 401(k) plans found an average participation rate of 67 percent in plans with no employer match, compared with participation rates near 80 percent in plans with some form of employer matching contribution.⁷

⁶See Hewitt Associates, Trends; Experience in 401(k) Plans, 1995 (Lincolnshire, IL: Hewitt Associates, 1995).

⁷See Buck Consultants, 401(k) Plans: Employer Practices; Policies, September 1996 (New York, NY: Buck Consultants, Inc., 1996).

Finally, the other notable point from the data presented above is that, despite the rapid growth over recent years in the number of salary reduction arrangements in small firms, it is at the small plan level that a noticeable gap in plan sponsorship remains. The question naturally arises as to what, if anything, can be done to fill this void? SIMPLE IRAs and SIMPLE 401(k)s were created by the Small Business Job Protection Act of 1996 for this very reason. Time will tell how successful they will be.

Table 1. Individual Retirement Account (IRA) Participation and Eligibility

	Number (thousands)	Percentage Eligible for Deductible IRA Contribution in 1993	Number Eligible for Deductible IRA Contribution (thousands)	Percentage of Eligible Contributing in 1992
<i>Single Workers</i>				
Total	40,151	88.9	35,684	4.7
Annual Earnings (1993)				
Less than \$10,000	10,655	100.0	10,655	1.4
\$10,000-\$24,999	17,974	100.0	17,974	4.7
\$25,000-\$34,999	5,879	100.0	5,879	8.4
\$35,000-\$49,999	3,547	21.6	766	12.1
\$50,000 or more	2,097	19.6	411	27.2
<i>Married Couples, Two Earners</i>				
Total Households	19,389	56.4	10,934	10.0
Annual Earnings (1993)				
Less than \$10,000	61	100.0	61	0.0
10,000-\$24,999	1,584	100.0	1,584	5.7
\$25-\$49,999	8,398	100.0	8,398	9.5
\$50,000 or more	9,345	9.5	890	23.1
<i>Married Couples, One Earner</i>				
Total Households	14,212	72.4	10,288	8.5
Annual Earnings (1993)				
Less than \$10,000	1,653	100.00	1,653	5.5
\$10,000-\$24,999	5,331	100.0	5,331	6.3
\$25,000-\$34,999	2,383	100.0	2,383	11.5
\$35,000-\$49,999	2,443	22.2	542	17.3
\$50,000 or more	2,402	15.8	380	21.9

Source: EBRI tabulations of the April 1993 Current Population Survey employee benefit supplement.

Table 2. Civilian Nonagricultural Wage and Salary Workers, Ages 16 and Over, by Salary Reduction Plan Sponsorship and Participation, 1988 and 1993

	Total Workers (thousands)		Sponsorship Rate ^a		Participation Rate ^b		Sponsored Participation Rate ^c	
	1988	1993	1988	1993	1988	1993	1988	1993
	Total	101,745	105,815	26.9%	36.8%	15.3%	23.8%	57.0%
Firm Size								
Less than 10	13,561	14,032	3.0	5.1	2.2	3.8	74.3	74.3
10-24	8,164	8,466	8.0	12.1	5.7	8.4	70.9	69.5
25-49	6,781	6,716	14.2	20.1	7.8	12.7	55.2	62.9
50-99	5,563	6,185	18.0	29.9	11.0	20.9	61.2	69.8
100-249	7,497	7,775	22.8	39.0	13.3	25.0	58.4	64.2
250 or more	51,274	54,709	41.5	53.2	23.4	34.5	56.2	64.9
250-499	(d)	5,471	(d)	49.9	(d)	32.5	(d)	65.2
500-999	(d)	5,485	(d)	47.8	(d)	30.5	(d)	63.7
1,000 or more	(d)	43,753	(d)	54.3	(d)	35.3	(d)	65.0
Annual Earnings, 1993 (\$)								
Less than \$5,000	7,595	7,275	3.8	8.1	1.1	1.6	28.0	19.9
\$5,000-\$9,999	10,119	10,419	8.8	13.1	2.6	4.4	29.7	33.6
\$10,000-\$14,999	12,463	15,015	15.3	22.7	5.6	10.0	36.6	43.9
\$15,000-\$19,999	13,658	14,238	22.2	35.7	10.3	19.5	46.2	54.6
\$20,000-\$24,999	10,956	12,408	30.2	43.9	15.5	26.7	51.2	60.8
\$25,000-\$29,999	9,841	9,737	35.4	46.5	20.0	31.1	56.7	66.8
\$30,000-\$49,999	20,993	19,858	43.9	57.1	27.8	41.3	63.2	72.4
\$50,000 or more	7,876	8,566	55.4	67.6	40.9	56.3	73.7	83.2

Source: EBRI tabulations of the May 1988 and April 1993 Current Population Survey employee benefit supplements.

^aThe fraction of workers whose employer sponsors a salary reduction plan for any of the employees at the worker's place of employment.

^bThe fraction of all workers participating in a salary reduction plan.

^cThe fraction of workers participating in a salary reduction plan among those whose employer sponsors a plan for any of the employees at the worker's place of employment.

^dData not available.

January 1997

The Reality of Retirement Today: Lessons in Planning for Tomorrow

EBRI
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Issue Brief

- The 1996 Retirement Confidence Survey, co-organized by the Employee Benefit Research Institute, Mathew Greenwald and Associates, and the American Savings Education Council, focuses on the realities of life for current retirees and implications for current workers.
- One-fifth of retirees have experienced a decline in their standard of living since they retired. One-fifth expect their lifestyle to worsen over the coming years. For many, retirement reality has not matched expectations, and one-quarter are not confident in their prospects for the remainder of their retirement. This represents a lack of confidence in their own financial preparation and a lack of faith in Social Security and Medicare. These findings should serve as a reality check for workers who need to plan now for retirement.
- Workers' confidence in their retirement income prospects dropped 12 percentage points over the past year. If this drop signifies that workers are being more realistic about their prospects and may be coming to terms with what they need to do to secure their own retirement income security, it is a good sign.
- Many workers are saving for retirement; however, this saving is not based on a plan designed to achieve a calculated goal. Only one-third of workers have tried to determine how much they will need to have saved by retirement so that they can live comfortably. Only one-third of these were very confident that they had determined an accurate figure. Furthermore, when asked how much they calculated that they would need to save, 42 percent could not give an amount. Therefore, less than 20 percent actually had a specific number with which to work.
- Americans are pessimistic regarding the Social Security system in its current state and its ability to maintain benefit levels into the future. At the same time, they are generally opposed to any form of benefit cuts and/or tax increases (except for higher income retirees). What types of changes would they accept? Apparently, they would accept investment of trust fund assets in private equity markets and/or the creation of individual Social Security 401(k)-like accounts as part of the system.

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This *Issue Brief* was written by Paul Yakoboski of EBRI and Allen Schiftenbauer of Mathew Greenwald and Associates, with assistance from the Institute's research and editorial staffs. Any views expressed in the *Issue Brief* are those of the authors and should not be ascribed to the officers, trustees, members, or other sponsors of EBRI, EBRI-ERF, or their staffs. Neither EBRI nor EBRI-ERF lobbies or takes positions on specific policy proposals. EBRI invites comment on this research.

Introduction

mainstream media. Retirees lead a carefree existence of golf, travel, and time spent with the grandchildren. Such an idealistic picture of retirement likely influences the way current workers view their own future retirement. But is this picture of today's retiree accurate?

The 1996 Retirement Confidence Survey (RCS), co-organized by the Employee Benefit Research Institute (EBRI), Mathew Greenwald and Associates, and the American Savings Education Council (ASEC), focuses on the myths and realities of life for current retirees and their implications for current workers' retirement savings behavior and attitudes. The 1996 RCS indicates that, for as many as one-quarter of retirees, retirement finances have not resulted in the stereotypical carefree existence. Today's unrealistic picture of retirement as a carefree existence may lead to a false sense of confidence on the part of many workers and influence the way people make personal decisions about retirement savings and view public policy questions.

This *Issue Brief* discusses these issues and other findings from the 1996 RCS.

Not Golden for All

than it was the first year they retired (8 percent say it is a lot worse), compared with 20 percent who reported that their lifestyle had improved over the course of their retirement (chart 1). Not surprisingly, money and finances, along with health problems, were the most often cited reasons

Today's retirees have it made, or so we are led to believe, by the images portrayed in the

for the decline.

Twenty-one percent of retirees said they expect their standard of living to get worse over the next several years (chart 1). Over one-half of these individuals cited fears of cost-of-living increases as the reason for their negative expectations. Most other reasons cited were also financial in nature.

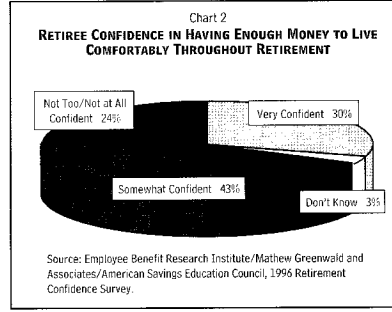
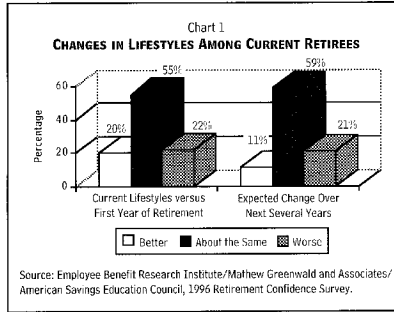
When asked to compare actual experience with expectations at the time of their retirement, 13 percent of retirees said that their overall lifestyle had been worse than expected (27 percent reported that it had been better). **Two areas notable for unmet expectations were health related. Twenty-seven percent of retirees reported that their health had been worse than expected, and 21 percent reported that their situation in terms of having enough money to cover medical expenses had been worse than expected. In addition, 19 percent reported unmet expectations in terms of having enough money to pay for most of the recreational, entertainment, and travel pursuits they desired in retirement.**

This is notable given that it is such activities and pursuits that many people view as the rewards of retirement.

When asked how confident they were that they will have enough money to live comfortably throughout their retirement, only 30 percent answered that they were very confident (chart 2). Of the remaining retirees, one-quarter (24 percent) had little confidence, and almost one-half (43 percent) were only somewhat confident that they will have enough money to live comfortably throughout retirement. The "somewhat confident" appeared to be in a precarious position, feeling that their retirement will be comfortable only if everything goes their way. However, any problem with excessive inflation or any number of other issues could cause serious difficulties for them.

This lack of confidence among those already retired appears tied to three distinct yet interrelated factors:

- fear of declining health and related medical

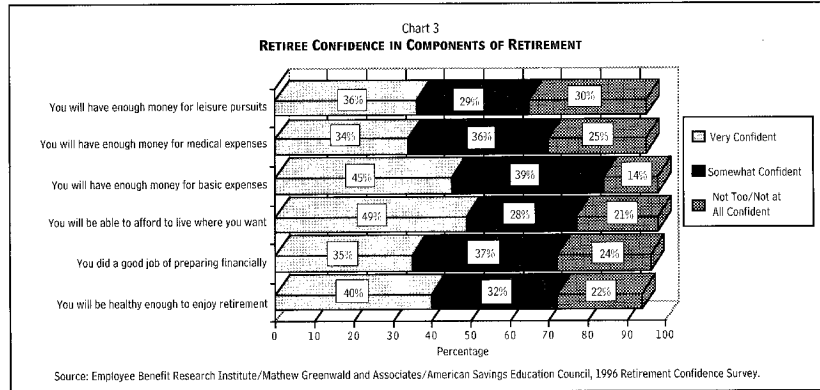


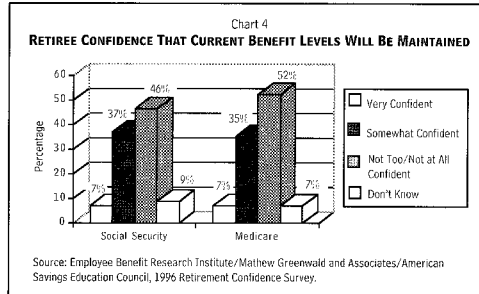
- **expenses,**
- **lack of confidence in their own personal financial planning for retirement, and**
- **concern over the future of Social Security and Medicare benefits.**

The first two factors emerged on examination of the details behind the overall confidence rating. Being able to afford to pay for medical expenses was the area with the lowest confidence rating, followed closely by having done adequate financial preparation for retirement and being able to pay for most leisure pursuits (chart 3). Consistent with their concern about financial preparedness, only 56 percent of retirees reported that they had any money they themselves saved for retirement. Of these, 76 percent did not begin saving until they were aged 40 or over.

The third theme contributing to relatively low confidence among today's retirees is uncertainty about two major sources of financial support—Social Security and Medicare. **Fewer than one-half of today's retirees expressed strong confidence that the Social Security and Medicare systems will continue to provide benefits equal in value to the benefits they receive today (chart 4). Only 7 percent of retirees were very confident that these two programs will continue to provide them with the benefits to which they have become accustomed.**

The importance of this lack of confidence about the continuing value of Social Security in driving overall concern about retirement is clear. Social Security is the most important source of income for retirees; almost two-thirds reported that it is either their most important or a





major source of income (chart 5). Money an employer put into a pension

plan was a strong second (48 percent). Only one-third mentioned their own savings, and 29 percent mentioned money they put into a savings or retirement plan through work. While only 7 percent of retirees reported employment as an important source of income for them, 23 percent reported having had a part-time job at some point after their retirement.

For many retirees, retirement has been disappointing in some sense from the very beginning. Almost one-half (48 percent) of retirees retired earlier than they had planned, and the reasons cited for early retirement tended to be negative and out of the individual's control. The single most frequently given reason was health problems (38 percent). This was followed by job elimination (16 percent), buy-out/early retirement offer (10 percent), and problems in the work place (7 percent). The fact that a relatively high proportion of retirees were forced into early retirement is another reason for their lack of adequate financial preparation.

These results demonstrate that there is a sizable fraction of the retired population leading, to some extent, a troubled existence. These findings should serve as a reality check for today's workers, who need to plan now for their retirement. One-fifth of retirees have experienced a

decline in their standard of living since they retired. One-fifth expect their

lifestyle to get worse over the next several years. For many, retirement reality has not matched expectations, and about one-quarter are not confident in their prospects for a comfortable existence for the entire remainder of their retirement. This lack of confidence is based on a lack of confidence in their own financial preparation for retirement and a lack of faith in government programs, i.e., Social Security and Medicare.

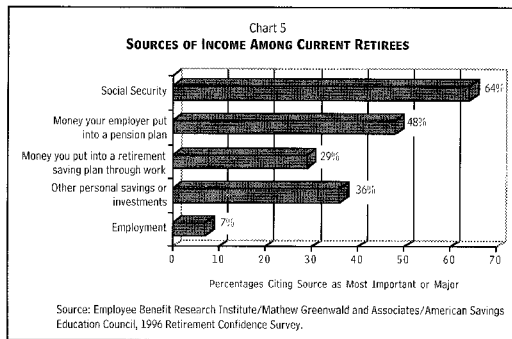
Worker Confidence Down

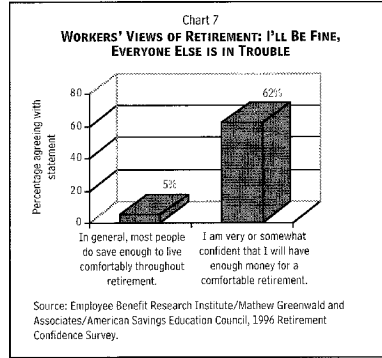
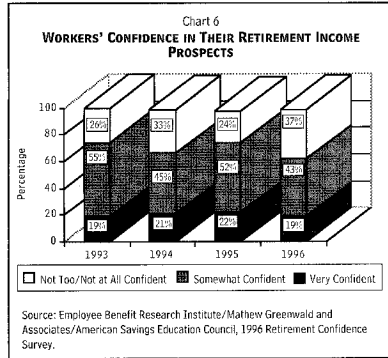
Workers' confidence in their retirement income prospects dropped sharply over the past year.

according to the 1996 RCS. While such a drop could have many causes, a distinct possibility is that the constant drumbeat of attention given to the need for baby boomers

to save for their retirement has begun to register with workers. As a result, they may have evaluated their situation and not been pleased. **If this dose of realism motivates action, then the drop in confidence is actually good news.**

In 1996, 19 percent of workers were very





confident that they will have enough money to live comfortably throughout retirement, compared with 22 percent in 1995 (chart 6). An additional 43 percent were somewhat confident in 1996 regarding their retirement income prospects, compared with 52 percent in 1995. Thus total confidence dropped 12 percentage points over the past year. **To the extent that this drop signifies that workers are being more realistic about their prospects and may be coming to terms with what they need to do to secure their own retirement income security, this drop is a good sign. If economic uncertainties spur people to plan better and save more, this is a positive development.**

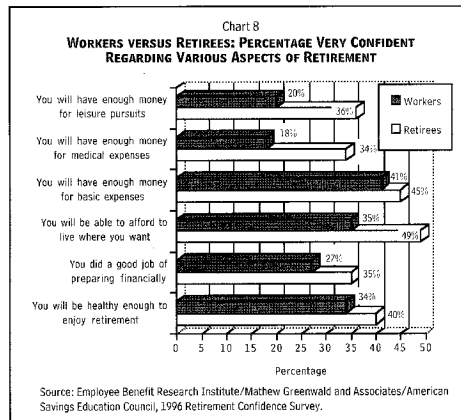
While workers are relatively confident in their own retirement income prospects, they are decidedly pessimistic regarding the prospects of their peers. **Only 5 percent of workers think that, in general, people in the United States save enough money to live comfortably throughout their**

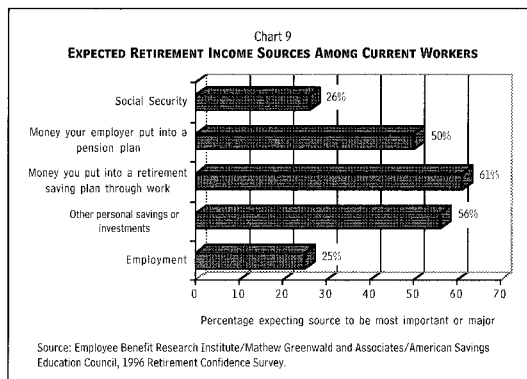
retirement years (chart 7). This view of others may actually reflect some underlying anxieties regarding their own situation.

For each aspect of retirement, today's workers were less confident about their futures than retirees. The gap in confidence ranges from a high of 16 points for the ability to pay for leisure activities and medical expenses to a low of 4 points for the ability to pay for basic expenses (chart 8).

Today's workers believe that their retirement income prospects will depend heavily on

their personal saving decisions. Sixty-one percent of workers said they expected money they save through a retirement plan at work to be the most important or a major source of retirement income for them (chart 9). Fifty-six percent expected other personal savings and investments to be the most important or a major source of retirement income. Fifty percent expected money that their





employer puts into a pension plan will be the most important or a major source of retirement income.

Workers are not counting on Social Security. Only one-quarter (26 percent) expected it to be the most important or a major source of retirement income (chart 9). Twenty-three percent of workers did not expect Social Security to be a source of retirement income for them, and an additional 50 percent expected it to be only a minor source. In addition, 79 percent were not too confident or not at all confident that Social Security will continue to provide benefits of value equal to those provided today, and 76 percent were not confident about the future of Medicare benefits.

When asked at what age they *realistically* plan to retire, 21 percent of workers responded before age 60, and an additional 25 percent said between age 60 and age 64. Only 12 percent said they planned on retiring after age 65. These would not appear to be realistic expectations for many, given the responses to other questions. This may be partially explained by a changing perception of what it means to be "retired." Indeed, almost two-thirds (65 percent) of workers thought that they will work after retirement. While a majority (51 percent) of workers who predicted they will be employed after retirement said they will do so to stay active, 19 percent said it will be out of financial necessity, and 20 percent said it will be to supplement other income.

Savers, Not Planners

An often repeated misperception is that earlier generations were good

savers and planners, while today's workers (and in particular, the baby boom generation) generally fail to save adequately

and prepare for the future. The data demonstrate that such views are wrong. When it comes to saving for retirement, today's workers have a better track record than today's retirees. Almost two-thirds (64 percent) of current workers have money set aside for retirement that they saved on a regular basis (aside from Social Security or an employer-funded pension but including 401(k)-like plans) (table 1). Furthermore, older workers are much more likely to report such savings. Eighty percent of workers over age 55 have money set aside for retirement that they saved on a regular basis, compared with 56 percent of workers under age 35. We can therefore expect that, as younger workers age, more of them will save for retirement on a regular basis. By comparison, only 56 percent of current retirees reported that they had money set aside for retirement that they saved on their own.

However, while many workers are saving for retirement, it is not savings based on a plan designed to achieve a calculated goal. Only one-third (32 percent) of current workers reported that they had tried to figure out how much money they will need to have saved by the time they retire so that they can live comfortably in retirement. Only 33 percent of these were very confident that they had determined an accurate figure. Furthermore, when asked how much they calculated that they would need to save, 42 percent could not give an amount. Therefore, less than 20 percent actually had a specific number with which they could work (table 1).

Among those who had not tried to make the calculation, the most important reason cited was, "It will not be helpful because I cannot save any more than I am

Table 1
**SAVING AND PLANNING BEHAVIOR
AMONG CURRENT WORKERS**

	Percentage
Workers with money set aside for retirement that they saved on a regular basis	64%
Workers who have tried to determine how much they need to have saved by retirement to live comfortably	32
Among these:	
Those who cannot give a dollar amount when asked	42
Those very confident that they were able to determine an accurate amount	33
Workers very confident in their ability to develop a good financial plan	26
Workers very confident in their ability to stick to a regular financial plan	45

Source: Employee Benefit Research Institute/Matthew Greenwald and Associates/American Savings Education Council, 1996 Retirement Confidence Survey.

currently saving" (45 percent cited this as a major reason). In addition, 36 percent cited "It is too far in the future to know what will be needed" as a major reason.

Among those who have tried to determine how much they need to accumulate, the most commonly cited source of information and/or advice was books and articles (78 percent). The next most common sources of information were a professional advisor (accountant, financial planner, stockbroker, etc.); a financial planning worksheet; information provided by employer; and friend, relatives, or work colleagues (all cited by a little over one-half). Computer software/programs were cited by only about one-quarter (28 percent).

While workers have limited confidence in their ability to develop a good financial plan, they are much more confident in their ability to stick to a regular financial plan. Twenty-six percent of workers said they were very confident in their ability to develop a good financial plan, and an additional 46 percent were somewhat confident. By comparison, 45 percent of workers were very confident in their ability to stick to a financial plan, and an additional 36 percent were somewhat confident.

Saving Through Work

The distinction between employment-based pensions and individual savings is becoming

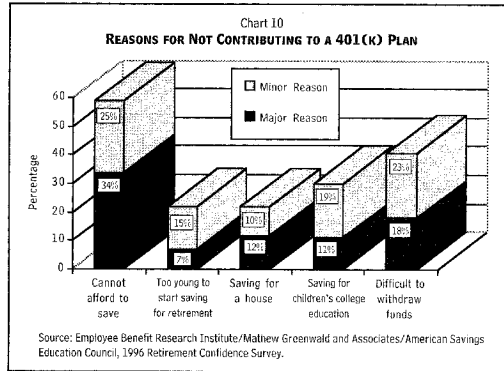
increasingly blurred with the continued growth of 401(k)-like plans in the work place. **Sixty-one percent of workers reported that their employer offered a retirement saving plan, such as a 401(k) plan, a 403(b) plan, a salary reduction simplified employee pension plan (SARSEP), or a 457 plan, that allows pretax worker contributions to the worker's own**

account. Three-quarters (74 percent) of workers who were offered a plan reported making contributions to it. Among those not contributing to

the plan offered them, the most common reason cited was that they could not afford to save (34 percent reported this as a major reason, and 25 percent as a minor reason) (chart 10). The next most commonly cited reason was that it is difficult to withdraw funds from such retirement savings accounts (18 percent reported this as a major reason and 23 percent as a minor reason). Thirty percent cited as a major or minor reason that they were saving for their children's education and they did not want to divert funds. Twenty-two percent cited saving for a house as a reason.

Workers contributing to a 401(k)-like plan were asked what the main factor was in determining how much they contribute. Thirty-one percent said that they contributed the most they could afford, and 30 percent said they contributed the maximum they were allowed to contribute (chart 11). Twenty-one percent contributed the maximum amount that their employer would match. Sixteen contributed the amount that they determined they should contribute.

Seventy-one percent of plan participants reported that their employer had provided them with educational material or seminars regarding the plan within the past 12 months, and, among these, 81 percent reported that they utilized the material or attended the seminars. Almost all reported that the material included a description of the investment options available in the plan and covered the advantages of saving in tax-deferred plans (98 percent and 96 percent, respectively). Over 80 percent reported that the material covered the effect of compounding over time and the principles of risk and return (83 percent and 81 percent, respectively). Three-quarters (77 percent) said the material covered the principles of asset



allocation and diversification. Two-thirds (66 percent) said the material covered estimating the amount needed to be saved for a comfortable lifestyle in retirement.

Participants were also asked about the usefulness of various sources of information when making decisions regarding participation in their 401(k) plan. The employer and/or plan service provider was cited as the most helpful (30 percent as very helpful and 45 percent as somewhat helpful) (chart 12). It is notable that 21 percent of participants did not use this source of information. Spouse was cited as the next helpful source, with a total of 58 percent citing a spouse as helpful (31 percent as very helpful). Friends and/or co-workers were cited by 58 percent as helpful (but only by 11 percent as very helpful). One-half of the participants did not utilize a financial professional, but the other half did find this source helpful.

Knowledge Lacking

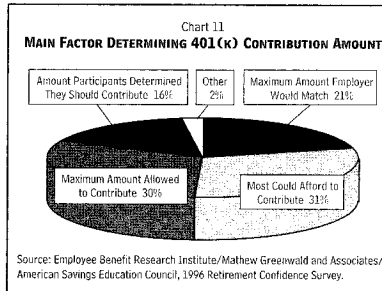
current workers' knowledge level (or lack thereof) with regard to basic retirement finance concepts is increasingly important. **The majority of working Americans appear to have a limited amount of financial knowledge regarding issues important in planning and saving for retirement. Based on a five question quiz in the 1996 RCS, one-third of all workers have a high degree of financial knowledge (four or five correct answers) regarding issues important in planning and saving for retirement. Fifty-five**

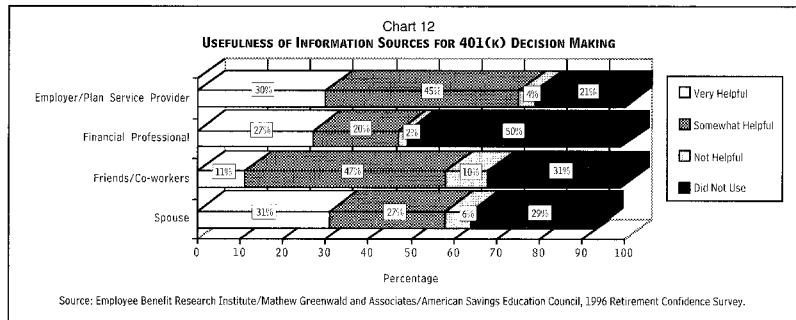
With more opportunity and responsibility to plan and save for retirement than previous generations,

percent have a moderate level of knowledge (two or three correct answers), and 11 percent have low knowledge levels (zero or one correct answer). These results closely mirror those from last year.

Financial knowledge levels did not vary notably with worker age, but they did tend to increase with worker earnings. Twenty-five percent of those earning less than \$35,000 had a high knowledge level, compared with 41 percent of those earning over \$50,000. Not surprisingly, similar results were found with worker educational levels. Twenty percent of those with a high school degree or less had high knowledge levels, compared with 49 percent of those with a high school degree. Even among those with a college degree, only one-half scored highly in terms of retirement financial knowledge.

Less than one-half (44 percent) of workers knew that a male retiring today at age 65 can expect to live to age 80, on average. Sixty-one percent of workers knew that the U.S. stock market has provided a greater return





on investment over the past 20 years than U.S. government bonds. Slightly over one-half (53 percent) of all workers knew that employer stock is typically a more volatile investment for employees than investing in a diversified portfolio of stocks. One-half of workers knew that the probability of losing money on an investment in a mixture of stocks from different industries goes down the longer you hold on to the investment. Eighty-six percent of workers knew that the average person retiring today will need 60 percent to 80 percent of his or her work income during retirement to maintain the same standard of living that he or she had just before retirement.

Social Security Reform

Reform of the Social Security system is now the subject of serious discussions in various circles. Current proposals for reform run the gamut from relatively minor adjustments to the existing system to major restructuring of the program. As previously mentioned, both workers and retirees are generally pessimistic regarding the system's prospects as it currently exists. But how do they view various reform proposals?

According to the 1996 RCS, the public is generally opposed to reforms that in some sense involve sacrifice, i.e., benefit cuts and/or tax increases. At the same time, the public tends to favor reforms that effectively trim benefits for higher income retirees and is also receptive to more dramatic reforms, especially if they hold out the possibility of a "free lunch" (chart 13 and chart 14).

Reform of the Social Security system is now the subject of serious discussions in various circles. Current proposals for reform run the gamut from relatively minor adjustments to the existing system to major restructuring of the program. As previously mentioned, both workers and retirees are generally pessimistic regarding the system's prospects as it currently exists. But how do they view various reform proposals?

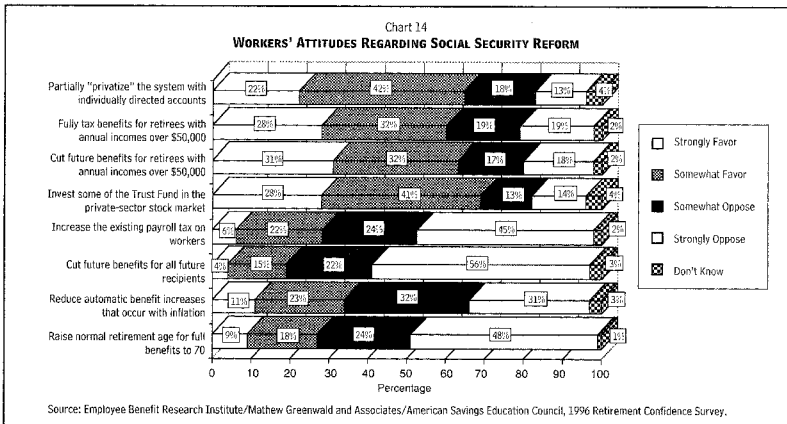
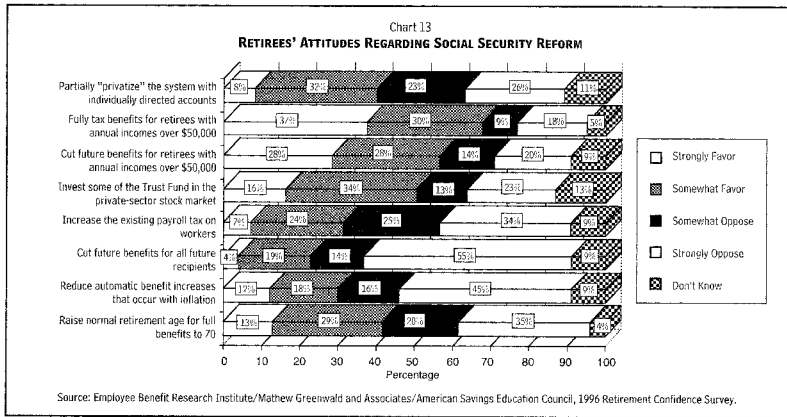
Benefit Cuts and Tax Increases

Any type of benefit cut is opposed by the majority of both workers and retirees. Majorities of both groups strongly oppose cutting future benefit payments for all future recipients (56 percent of workers and 55 percent of retirees). An additional 22 percent of workers and 14 percent of retirees somewhat oppose such cuts, for total percentages opposed of 78 percent of workers and 69 percent of retirees.

Benefits can also be cut indirectly by raising the retirement age and/or by scaling back cost-of-living adjustments (COLAs), benefit increases that occur automatically with inflation. About 60 percent of each group opposes reducing the level of the automatic COLAs that occur with inflation. However, retirees are more strongly opposed to COLA cutbacks than workers; 45 percent of retirees strongly oppose such change as compared with 31 percent of workers. Majorities of both groups oppose raising the retirement age, but, not surprisingly, current workers are more strongly opposed. Seventy-two percent of workers and 55 percent of retirees oppose raising the normal retirement age for collecting full benefits to age 70.

In addition, majorities of both groups oppose increasing the existing payroll tax on workers. Sixty-nine percent of workers oppose such reform, with 45 percent strongly opposed. Fifty-nine percent of current retirees oppose such reform, with one-third (34 percent) strongly opposed.

Both groups favor cutting benefits for retirees with higher incomes. Among retirees, 67 percent favor fully taxing benefit payments of retirees with incomes over \$50,000, and 56 percent favor cutting future benefit payments for retirees with incomes over \$50,000. Among workers, such



proposals are favored by 60 percent and 63 percent, respectively. Interestingly, even majorities of workers with annual incomes over \$50,000 favor such proposals.

Trust Fund Equity Investment

Respondents were also asked about investing some

of the trust fund in the stock market as opposed to keeping it all invested in government securities. Sixty-nine percent of workers favored such change (with 28 percent strongly favoring). One-half of retirees favored such reform. Over the long term, the stock market has historically earned greater returns than government bonds. Individuals apparently like the idea of the trust fund earning a greater rate of return

than it currently does. In some sense, they are expressing a preference for the proverbial "free lunch," but they may not understand the short-term volatility that comes with equity investing and what this may mean for the system.

Individual Accounts

Finally, respondents were asked their opinion of a proposal to deposit a fraction of their payroll taxes in an individual account over which they would exercise investment control. Income generated from their account, combined with a guaranteed base benefit, would then constitute their total Social Security benefit. Benefits could be greater or less than those currently provided under the present system.¹ This is the one reform proposal on which the majority of workers and retirees disagreed. Sixty-four percent of workers favored such reform, with 22 percent strongly favoring it. Only 40 percent of current retirees favored such reform. Obviously, such reform would not impact those already receiving benefits from the program. The older the worker, the less likely he or she was to support this proposal. Support did not vary notably with worker income levels.



Workers' confidence in their retirement income prospects is down notably over the past

¹ The exact question wording was: "Currently, all Social Security taxes in excess of those needed to pay current benefits are invested by the government in government bonds. Some people have proposed that individuals be allowed to decide how some of the money they pay in Social Security taxes is invested. Upon retirement, individuals would receive a reduced guaranteed Social Security payment, but they would also receive income from the investments they chose. The total of these two sources of money could be higher than current guaranteed benefits if the individual's investments did well or lower if the individual's investments did not do well. How do you feel about this proposal?"

year. In light of the fact that up to 25 percent of current retirees consider their retirement to be in some sense financially troubled, this drop in confidence may actually be a good thing. If such economic uncertainty motivates workers to plan better and save more, they will be better off in the long run. It is evident from this year's RCS results that most workers are not planning, and many have limited financial knowledge in areas of retirement saving.

Americans' opinions regarding the Social Security system are paradoxical. They are generally pessimistic about the current system and its ability to maintain existing benefit levels into the future. At the same time, they are generally opposed to any form of benefit cuts (except for higher income retirees) and/or tax increases. What types of changes would they be willing to accept? Apparently, they would accept investment of some trust fund assets in private equity markets and the creation of individual Social Security 401(k)-like accounts as part of the system. This is likely indicative of two phenomena: first, a desire for relatively painless solutions and second, some degree of distrust of the federal government in this area. Workers would be willing to have some of the money in their name and under their control, as opposed to trusting in government promises that are subject to change. This is the environment within which the nation must find solutions to the long-term solvency issues of Medicare and Social Security.

The future retirement income adequacy and security of many will to a large degree be directly tied to the success of efforts to educate workers in these areas. Contrary to popular opinion, much saving is occurring among workers, although few would argue it is enough. What is currently missing is saving based on a calculated goal and a plan to reach that goal. The next frontier is moving beyond creating savers to creating planners who then save.

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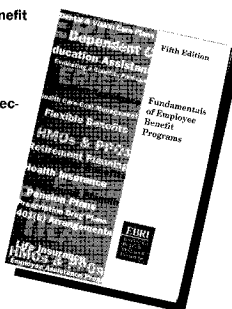
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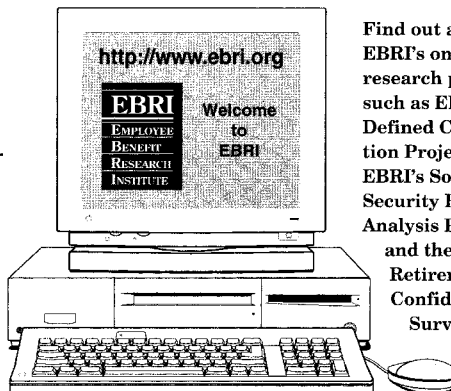
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Chairman ARCHER. Thank you, Dr. Yakoboski.
 Our last witness is Dr. William Gale, who is also no stranger to the Committee. We are happy to have you back before the Committee. If you will identify yourself for the record, we would be glad to receive your testimony.

**STATEMENT OF WILLIAM G. GALE, JOSEPH A. PECHMAN
FELLOW, ECONOMIC STUDIES PROGRAM, BROOKINGS
INSTITUTE**

Mr. GALE. Thank you very much, Mr. Chairman, for inviting me to testify. It is a pleasure to be here today to talk about IRAs.

My testimony is based in part on the research I have conducted over many years on the effect of IRAs on saving, and let me start by saying that I think the low level of private and national saving is one of the most important economic problems we face in the United States today, but in terms of thinking about IRAs, we need to think about IRAs in the larger context of tax policy toward saving.

It has been noted many times in the hearings so far, that certain forms of income are taxed at very high, even punitive rates. What should also be noted is that a very large proportion of capital income or saving is taxed at either zero or negative rates. Currently, people can invest in IRAs, defined benefit plans, defined contribution plans, 401(k)s, Keoughs, 403(b) plans, 457 plans, Federal Government thrift plans, SIMPLE plan, SEP plans, fixed and variable annuities, and life insurance saving. There is no shortage, in short, of opportunities for tax-deferred saving.

In fact, there is so much tax-deferred saving right now that tax-deferred saving accounts for roughly 100 percent of net personal saving in the last decade.

Over the last two decades, tax-deferred saving has gone up rather dramatically, at the same time that the personal saving rate has come down. If the contributions to tax-preferred saving rates were, indeed, net additions to private saving, we would expect that private saving would have gone up with this surge in tax-preferred saving, but in fact, we see the opposite. Private saving has either held constant or fallen.

One reason for that can be given by thinking about how people make contributions to IRAs. There are basically two ways to contribute to an IRA, a painless way and a painful way. The painless way is pretty obvious. You take money from one account, a taxable account, and move it into an IRA. You take money you would have saved anyway, put it in an IRA, or you borrow money and you put it in the IRA. Those are all painless because they don't force you to reduce your current consumption, but they do allow you to take advantage of the tax benefit of having an IRA.

The painful way to contribute to an IRA is to raise your saving; that is, to reduce your consumption and reduce your current standard of living.

There has been a lot of research on this topic. I have been part of that research, and my summary of the research is that there are a number of statistical problems in this literature, but studies that correct for the problems give the intuitive and I think the correct result, which is that people so far have contributed to IRAs in mainly the painless way; that is, they have found ways to get a hold of the tax break without reducing their living standards. I don't blame people for doing this. It is exactly what I do when I contribute to an IRA or a tax-deferred account, but as a matter of policy, it indicates that the programs have not been as effective as they could be.

How big of an effect on saving might we expect if we expanded IRAs? Well, in the "golden years," before 1986, IRAs were about 1 percent of GDP, but the expansion is only partial. So let us suppose that contributions rise by about one-half of 1 percent of GDP. If half of those contributions are new saving, which is an average from the literature, and then you deduct out government saving, you get the national saving rate going up by one-eighth of 1 percentage point of GDP. So the IRA expansion would raise saving from 5 to about 5.12 percent.

That is only the effect of expanding the income limits. The other part of these proposals would allow penalty-free withdrawals for other purposes; for example, first-time home purchase, unemployment, medical expenses, education expenses. If this provision were to be enacted, I would caution that it should not apply to preexisting balances. There are \$1.2 trillion in preexisting IRA and Keough balances. If people start taking that money out for other purposes, that will reduce the saving rate, not raise it.

The problem here is the obvious one. You cannot encourage consumption and saving at the same time. So, if withdrawals are allowed for preexisting assets, the saving rate could very well fall if we expand IRAs, as proposed by the administration.

As a matter of tax policy, expanding IRAs would definitely make the system more complicated. I know, Mr. Chairman, that you would like to get the IRS out of people's lives. I ask you to envision what kind of IRS rules and procedures would be required to verify that a certain IRA withdrawal was actually made for a certain purpose, like unemployment or health or education. That would, if anything, make the IRA more intrusive or increase the level of evasion in the existing tax system.

So let me close by thinking about the bigger picture. There is a case, a mixed case, to be made for removing taxes on all capital income and moving more toward a consumption tax. That raises a whole host of new issues, but I think there is a legitimate case to be made, and there are legitimate issues to be talked about.

The point I would like to leave you with is that moving part way there, that is, increasing the crazy quilt of tax policy toward savings, increasing the number of loopholes, can actually be a step backward. Moving partway there can actually be worse in terms of tax complexity, tax efficiency, tax equity, than moving all the way there. Even if we think we should move all the way there, it is not clear that moving partway there is a good idea.

So what I would like to see the Congress do, returning the focus on raising the national saving rate, is to focus on financial education, to focus on pension reform, and to look quite seriously at Social Security reform.

Modifying IRAs, even if it works, is not going to have a large effect, and my suspicion is that is not going to work on the basis of the evidence I mentioned earlier.

Thank you very much.

[The prepared statement and attachments follow:]

Statement of William G. Gale, Joseph A. Pechman Fellow, Economic Studies Program, Brookings Institute

Mr. Chairman and Members of the Committee:

The views expressed here are my own and should not be ascribed to the officers, trustees, or staff of the Brookings Institute.

DISCUSSION

Thank you for inviting me to testify today on the issue of expanding Individual Retirement Accounts. The low level of private and national saving is one of the most important economic problems facing our country today and in the future. American saving rates have been very low in recent years, compared to other countries and by historical standards. On a national level, more saving could finance increased investment. This in turn can make workers more productive, and raise their wages and standards of living. At the household level, increased saving helps people prepare for retirement, provides a cushion for financial downturns, and assists in meeting other financial goals.

Many potential factors have been offered to explain the saving decline. These include: increased intergenerational transfers to the elderly; expansions of government programs that reduce the need to save (including Social Security, Medicare, Medicaid, unemployment insurance, workers' compensation, housing guarantees, and student loans); liberalization of debt markets; demographic changes; and the slowdown in income growth since the mid-1970s. Tax considerations are notably absent from this list; indeed, the general tax and inflation environment facing savers may be at least as favorable today as it has been in the past. The highest marginal tax rates are relatively low by historical standards and inflation, which raises the effective tax rate on financial assets, is quite low. Despite these considerations, tax policy is sometimes claimed to be an effective way to raise the saving rate substantially.

Tax policy toward saving is inconsistent. Some assets are taxed at high effective rates, while a large number are taxed at rates that are very low and can even be negative. There is no shortage of tax-preferred methods of saving. Current options include IRAs, defined benefit pensions, defined contribution pensions, 401(k) plans, Keoghs, 403(b) plans, 457 plans, federal government thrift saving plans, SIMPLE plans, SEP plans, fixed and variable annuities, and life insurance saving. Moreover, housing and municipal bonds are also tax-favored, as are the capital gains that accrue to unincorporated businesses. Over the last several decades, as the personal saving rate has fallen, tax-favored saving (via pensions, 401(k)s, IRAs, Keoghs, and life insurance) has become an ever more important component of total personal saving. Between 1986 and 1993, saving in tax-preferred accounts constituted about 100 percent of net personal saving (Table 1). This does not mean there was no other saving activity, it just means that any gross saving in other accounts was fully offset by withdrawals from those accounts or by increases in borrowing.

Wide variations in effective tax rates on saving creates opportunities for investors to shift funds into the most tax-preferred accounts. The variation in rates, coupled with the tax-deductibility of interest payments, creates opportunities to game the system further by borrowing, deducting the interest payments, and investing in a tax-preferred asset.

IRAs are just one more patch in the crazy quilt of saving policy. Contributions of up to \$2,000 per year are tax-deductible for households with income up to prescribed limits. Deductibility is then phased out as income rises further. Balances accrue tax-free. Ordinary income taxes are due on any withdrawals, and a 10 percent penalty is also assessed on withdrawals that are not related to death or disability, but occur before the account holder is 59.5 years old.

Several current proposals would amend IRAs in a number of ways, including:

- Raising the income limits on deductible IRA contributions; indexing the income and contribution limits. Creating back-loaded IRAs: In a back-loaded IRA, the contribution is not deductible, but earnings and withdrawals are free of taxes and penalties, provided the funds were held in the account for a specified period, usually 5 years.
- Allowing penalty-free (and income-tax-free) withdrawals for specified purposes such as education, medical expenses, first-time home purchases, long-term unemployment, or business start-up expenses.

These proposals involve issues of tax policy, budget policy, retirement income security, and saving policy.

TAX POLICY CONSIDERATIONS

Expanding IRAs would be counterproductive tax policy. The IRA proposals would make the tax system more complex and intrusive. Serious consideration of how the IRS would verify that a particular withdrawal was made for a particular purpose suggests compliance and enforcement difficulties. Enforcing the combined limits on IRAs and elective deferral plans would cause further compliance headaches. Tax debates in 1996 correctly emphasized the importance of broadening the base, removing loopholes, and reducing rates in a revenue-neutral manner. As we move into 1997, proposals that expand IRAs move in exactly the opposite direction.

While IRAs are often described as tax-deferred saving, the effective tax rate on IRAs is typically zero or negative. The effective rate is zero if the tax rate that applies to the deductible contribution is equal to the rate that applies to the withdrawal. However, since marginal tax rates have fallen since 1986, and since people typically face lower marginal tax rates in retirement than during working years, the effective tax rate for many IRA holders is likely to be negative. For example, a household that deducts a \$2,000 IRA contribution at a 28 percent tax rate, holds the asset for 20 years at a 10 percent annual return, and withdraws the funds at a 15 percent tax rate pays an effective tax rate of *negative* 9 percent on the IRA. Punching a hole in the tax code to generate more assets with negative effective tax rates is inefficient and inequitable. Good tax policy would even out the taxation of all forms of saving, and possibly reduce the overall level of taxation on saving.

BUDGET POLICY CONSIDERATIONS

Expanding IRAs would also be counterproductive budget policy. First, it would create a new entitlement for anyone with enough funds to place money in a designated account. The fact that IRAs are tax rules rather than spending programs should not blind us to the essential equivalence of an entitlement set in the tax code and one set on the spending side. Tax entitlements are just as costly (and often more difficult to discern) than spending entitlements. The IRA entitlement would accrue largely to households in the top part of the income distribution, and would provide larger entitlement payments (i.e., tax cuts) to wealthier households who contributed more or faced higher tax rates. The key to long run budget control is to eliminate or reduce entitlement obligations rather than increase them.

Second, current budget procedures understate the cost of back-loaded IRAs. The requirement of a 5-year holding period before penalty-free withdrawals are allowed effectively places most of the costs beyond the five-year budget window. Budget policy should move toward more complete accounting of the costs of government programs.

Third, for any given amount of contributions, allowing both traditional front-loaded IRAs and back-loaded IRAs will prove more expensive in revenue terms than having either one. Other things equal, people who believe their tax rate will be lower when they withdraw the funds than it is now will tend to choose front-loaded IRAs, so they can take the deduction at the relatively higher current tax rate. Likewise, people who believe that their tax rate upon withdrawal will be lower than their current rate will tend to choose back-loaded IRAs to obtain the biggest tax cut.

RETIREMENT INCOME CONSIDERATIONS

Expanding the conditions for penalty-free IRA withdrawals would undermine the retirement income goals of IRAs, and could *reduce* both saving and tax revenue. One can imagine the list of favored uses of IRA funds expanding indefinitely. One can also imagine the list of favored accounts expanding as well: if IRA funds can be tapped, why not Keoghs, SIMPLE plans, SEPs, 401(k)s, pensions, or fixed and variable annuities? Moreover, there would be difficult administrative problems associated with minimizing abuse of these provisions. These problems will make the tax code more complex, and will require the IRS to gather more information, which could be quite intrusive, or risk not enforcing the provisions.

If withdrawals are allowed for new, favored uses of funds, two considerations are paramount. First, the withdrawals should be allowed only for funds contributed after legislation is enacted. As of the end of 1995, IRA and Keogh balances totalled \$1.2 trillion. These funds were placed in the accounts with the understanding that they were to be held until retirement or would face a penalty. If these funds become eligible for penalty-free withdrawal, the saving rate could actually drop. For example, suppose that in one year, 5 percent of these funds were removed for other purposes. That would represent about a withdrawals of about \$60 billion, or about 20 percent of personal saving. Second, funds withdrawn from deductible IRAs should

face income taxes, even if the penalty is waived. Otherwise, the entire withdrawal will *never* have been taxed, which would create obvious inequities and inefficiencies.

SAVING POLICY CONSIDERATIONS

All of these problems in tax policy, budget policy, and retirement income policy might be worth the cost if IRA expansions were certain to raise private and national saving substantially. The effect of IRAs on saving is the subject of considerable controversy, however, so it is useful to start with some basics.

The single most important factor is that *IRAs do not provide incentives to save*. Instead, IRAs provide incentives to place funds in a designated account. The distinction is crucial.

There are many ways to finance IRA contributions. One way, of course, is to raise saving. This involves consuming less, or to put it bluntly, reducing one's current standard of living. This is the painful way of taking advantage of the tax breaks afforded by IRAs. There are, however, relatively painless ways to capture the tax break as well. For example, the contribution may be financed by transferring existing taxable assets into IRAs, by reallocating into an IRA current or future saving that would have been done outside the IRA, or by increasing household debt. These painless methods of contributing to an IRA do not raise overall private saving. Thus, IRAs and other so-called saving incentives do not require that contributors save, or save more than they would have otherwise.

How are people likely to react to IRAs? Common sense suggests that people will try to capture the tax breaks in the least painful way possible. A reasonable conjecture is that one reason IRAs are so popular with taxpayers is precisely because taxpayers do not need to reduce their standard of living (raise their saving) to claim the tax break.

Research findings back up this claim at the most general level. Economists Joel Slemrod of the University of Michigan, and Alan Auerbach of the University of California, surveying a broad range of studies of the effects of the tax reform act of 1986, have concluded that similar phenomena arise in a host of tax-related activities. They find that decisions concerning the timing of economic transactions are the most clearly responsive to tax considerations. The next tier of responses involves financial and accounting choices, such as allocating a given amount of saving to tax-preferred saving versus other saving. The least responsive category of behavior applies to agents' real decisions, such as changes in the level of saving. This hierarchy of responses, applied to IRAs, suggests that most IRA contributions are not new saving.

(A) *What proportion of IRA contributions is new saving?*

In recent years, a number of studies have examined the effects of IRAs on saving and reached a variety of conclusions.¹ The crucial issue in this literature is determining what households who had IRAs would have saved in the absence of these incentives.

Several factors, however, make this a difficult problem and one subject to a series of biases that overstate the impact of IRAs on saving. Analyses that ignore these issues overstate the impact of IRAs on saving. No study that corrects for these biases finds that IRAs raise saving. Rather, Engen, Gale and Scholz (1996a, b) show that accounting for these factors largely or completely eliminates the estimated positive impact of IRAs on saving found in some studies.

First, saving behavior varies significantly across households. Households that hold IRAs have systematically stronger tastes for saving than other households. Thus, a simple comparison of the saving behavior of households with and without IRAs will be biased in favor of "showing" that IRAs raise saving. To oversimplify somewhat, suppose there exist two groups: "large" savers and "small" savers. We would expect to see that IRA holders (where "large" savers are overrepresented) would save more than non-IRA holders (where small savers were overrepresented). But this would provide no information about the effects of IRAs *per se*, unless there is a way to control for the observable and unobservable differences between large and small savers.

Even researchers that claim that IRAs raise saving recognize that the heterogeneity of saving behavior is a crucial factor in this literature. What is often overlooked, however, is that the implication of heterogeneity is that findings such as "households with IRAs saved more than households without IRAs," do *not* imply anything

¹This section is based on Engen, Gale and Scholz (1996a,1996b), which provides details and additional evidence for the points made here.

about whether IRA contributions represent new saving, since those households would have been expected to save more to begin with.

Due to heterogeneity in saving, studies that compare IRA contributors with non-contributors tend to “find” that IRAs raise saving (Hubbard 1984, Feenberg and Skinner 1989, Venti and Wise, 1987, 1988, 1990, 1991). However, statistical tests reject the validity of such comparisons (Gale and Scholz 1994.) In contrast, studies that compare one group of contributors to another tend to find much smaller or negligible effects of IRAs, or expansions of IRAs, on saving (Gale and Scholz 1994, Attanasio and De Liere 1994, Joines and Manegold 1995). By comparing two groups of contributors, these studies more effectively isolate groups with similar propensities to save and hence provide a more valid comparison.

A second problem is that saving and wealth are net concepts and are broad concepts. If a household borrows \$1000 and puts the money in a saving incentive account, net private saving is zero. The data indicate that households with saving incentives have taken on more debt than other households. Hence, studies should focus on how saving incentives affect wealth (assets minus debt), not just assets. Because financial assets are small relative to total assets, studies that focus only on the effects of saving incentives on financial assets may have particularly limited significance.

Since the expansion of IRAs in the early 1980s, financial markets, pensions, and Social Security have undergone major changes. Pension coverage (other than 401(k)s) fell over the 1980s, and social security wealth was reduced in the 1983 reforms. Both of these factors would have caused people to have accumulated more assets in the late 1980s or early 1990s than in the early 1980s. Moreover, the reduction in inflation and tax rates that occurred over the 1980s made financial assets relatively more attractive than tangible assets (such as housing). This led to strong increases in the stock market and to shifts of wealth from nonfinancial to financial forms. For all of these reasons, it is important to study the impact of IRAs on broad wealth measures and to control for other events that occurred during the 1980s.

Studies that examine only financial assets often find a large impact of IRAs on saving (Venti and Wise 1992, 1996). But extensions of those studies indicate that the effects disappear when the analysis examines the impact on broader measures of wealth that include debt or nonfinancial assets and include the impact of events that occurred during the 1980s (Engen, Gale and Scholz 1996a, b).

Third, IRA balances represent pre-tax balances; one cannot consume the entire amount because taxes and perhaps penalties are due upon withdrawal. In contrast, contributions to other accounts are generally not deductible and one may generally consume the entire balance in a taxable account. Therefore, a given balance in a saving incentive account represents less saving (defined either as reduced previous consumption or increased future consumption) than an equivalent amount in a conventional account.

Analyses that correct for these biases indicate that little if any of the overall contributions to IRAs have raised private or national saving. This conclusion arises consistently from evidence and estimates from a wide range of methodologies, including time-series data, cross-sections, panel data, cohort analysis, simulation models, and analysis of evidence from Canada (Engen, Gale, and Scholz 1996a, b).

(B) Who Contributed to IRAs and Why it Matters

Supporting evidence for this view comes from data on who contributed to IRAs. Table 2 shows that households with IRAs in 1986 were very different from households that do not have IRAs. In particular, compared to households without IRAs, the typical IRA holder had seven times the non-IRA financial assets, four times the overall net worth, and eight times the saving. Although some of these differences are due to observable characteristics, there is widespread agreement that households with IRAs tend to have stronger unobservable tastes for saving than do observationally equivalent households without IRAs.

Two types of households will be most able and hence most likely to make painless contributions, that is, contributions that do not raise private saving. The first is households that have large amount of other assets. These households have more existing assets to shift, typically have more current saving to shift, and have less of a need to maintain all of their assets as precautions against emergencies. The second is older households, who are less likely to face a binding early withdrawal penalty. In the extreme, people older than 59.5 years face no early withdrawal penalties. For each group, IRAs are good substitutes for the saving those households would do anyway, so the IRA contribution will be unlikely to represent new saving.

Data from the 1980s show that households with non-IRA financial assets² over \$20,000 in 1986 (about \$28,600 in 1996 dollars) or who were 59 or older made more than two-thirds of all IRA contributions in the 1983–6 period. Households who had non-IRA financial assets in excess of \$40,000 (about \$57,200 in 1996 dollars) or where the head was 59 or older made half of all IRA contributions during this period. Thus, while some people have argued that many of the *accounts* were held by middle class households, the data show that most *contributions* were made by households that would consider IRAs and other saving good substitutes. This suggests that the overall effects of IRAs on saving were likely to have been small at best.

In contrast, contributions will represent a net addition to saving only when they are financed by reductions in consumption, which will occur only when IRAs and other saving are poor substitutes for one another. This is more likely to occur for households that have lower asset holdings, and are younger. Thus, if IRAs are to be expanded, the expansion should be targeted to lower-income groups. Higher income groups will typically have higher assets and will find it easier to substitute other assets into IRAs.

(C) Aggregate Effects of Expanded IRAs on Saving

How much would expanding IRAs raise national and private saving? One can get some perspective on this issue by noting that net national saving has fallen from 8 percent of net national product in the 1950s, 1960s, and 1970s, to 4.1 percent in the 1990s. Personal saving has fallen from 7 percent of personal disposable income between 1950 and 1980, to under 5 percent in the 1990s.

One way to gauge the effect of *all* tax policy on saving is to consider the effects of replacing the income tax with a consumption tax. Estimates by Engen and Gale (1996) suggest that a cold-turkey switch to a pure consumption tax—with no personal exemptions or transition relief—would raise the saving rate by about 1.5 percentage points in the short run and by about 0.5 percentage points in the long run. Output per capita would rise by about 1.5 percentage points over the first 10 years. These effects are positive, but are modest compared to the decline in saving noted above.

The results also provide a useful perspective on what targeted tax policy changes can achieve. If a complete overhaul of the income tax system raises the saving rate by at most 1.5 percentage points, only a much smaller impact can be expected of policies that tinker around the edges of the system.

The aggregate impact of expanding IRAs would be tiny. From 1982 to 1986, IRA contributions constituted about 1 percent of GDP. Since then, however, tax rates have fallen and other saving incentives have proliferated. Moreover, expanding income limits for deductible IRAs would only affect a small portion of the population. If contributions rose by 0.5 percentage points of GDP and—splitting the difference among the studies—about half of those contributions were new saving, private saving would rise by 0.25 percentage points. But, assuming an effective federal and state tax rate of about 25 percent, government saving would fall by about one fourth of the contributions, so the net increase in national saving would be about 0.12 percentage points over the next few years.

Note that this estimate does not include the impact of allowing penalty-free (and income-tax-free) withdrawals for specified purposes. If these withdrawals are allowed from pre-existing balances, or if the withdrawals are made free of income tax, the impact on private and national saving of expanding IRAs could well be negative.

(D) Short-run versus Long-run Effects of IRAs on Saving

Some commentators (including Engen and Gale 1993) have made the point that the short-term effects of IRAs are likely to be less favorable than the long-term effects. The idea is that when IRAs are introduced, people will shift funds from taxable sources into IRAs so the contributions at first will not be new saving. After awhile, the people who contribute to IRAs may run out of funds to shift so that IRA contributions may eventually become new saving. For example, in a simulation model in Engen, Gale, and Scholz (1994), IRAs reduce short-term saving, but raise the long-term saving rate by 0.2–0.3 percentage points.

The crucial issue then becomes how long does it take until the saving rate rises? In Engen, Gale, and Scholz (1994) it takes 49 years for the wealth to income ratio to exceed its original (pre-IRA value). Some IRA proponents have reasoned that since the typical household has very little in pre-existing financial assets, the transition period will be very short: a year or less.

²Financial assets as defined here do not include employer-provided pensions 401(k) plans, or after-tax thrift plans.

The logic of a short transition period is misleading for two reasons. The first is simply that the typical household in 1986 did not have an IRA, so the typical household is irrelevant to the debate about how long the transition will last. The relevant households are those that contributed to IRAs and in particular those that continued to contribute to IRAs: Did these households have many pre-existing assets that they could shift into IRAs? The answer here is a resounding “yes.” Table 2 shows that pre-existing asset balances are high among household with IRAs. The typical IRA household in 1986 had over \$20,000 in non-IRA financial assets. Among households that contributed to the limit for three years in a row, typical financial asset balances were \$40,000. It is clear that for these households, IRAs could be financed from pre-existing asset balances for several years without raising saving.

The second problem with the proponents’ logic is even more important: it ignores IRA contributions that are financed by current or future saving that would have been done even in the absence of IRAs. These contributions do not represent new saving. The table shows that typical IRA households and 3-year limit contributors have extremely high levels of other saving relative to their IRA contributions and so could easily finance contributions out of saving that would have been done anyway. The median 3-year saving level for 3-year limit contributors in the SCF was \$60,000. Surely, it would not be difficult for many of them simply to shift \$12,000 of that into an IRA. The median 3-year saving level for the typical IRA contributor was \$23,000. This is certainly large enough to fund all or most of a typical three years worth of contributions. These figures suggest that among households that did contribute to IRAs, there was a large *on-going* source of funds from which IRA contributions could be financed without raising saving. There is every reason to think the transition period could take a very long time.

A second reason IRAs may raise long-term saving is that workers who leave jobs often roll their pension balances over into an IRA. Thus, the IRA provides a convenient way to keep the money “tied up” rather than encouraging people to spend the funds prematurely. Over long periods of time, the cumulative effect of having fewer people cash out their pension could raise the saving rate. Two caveats, however, should be noted. First, any such effect does not seem to have occurred yet. Second, this factor is already fully operable under the existing IRA system. No expansion of IRAs is needed.

(E) Did Advertising Make IRA Contributions New Saving?

Some commentators have asserted that the heavy advertising of IRAs means that IRA contributions were new saving. However, while it seems likely that IRAs were advertised heavily by the financial industry in the 1982–6 period, that fact provides no information as to whether the source of IRA contributions was new saving (reduction in living standards) or shifted assets, redirected saving, or increases in debt. There is certainly no *evidence* to support the notion that advertising for IRAs affected the level of saving.

Looking at the ads themselves, however, suggests that advertising may actually encourage asset shifting, rather than new saving. Some ads explicitly advocated financing IRAs with debt as an “easy” way to obtain the tax break (see Feenberg and Skinner 1989). Aaron and Galper (1984, p. 5) report the following ad from the New York Times in 1984:

Were you to shift \$2,000 from your right pants pocket into your left pants “pocket,” you wouldn’t make a nickel on the transaction. However, if those different pockets were accounts at The Bowery, you’d profit by hundreds of dollars Setting up an Individual Retirement Account is a means of giving money to yourself. The magic of an IRA is that your contributions are tax-deductible.”

For obvious reasons, advertising seems more likely to emphasize the possibility of painless contributions, which don’t raise saving, rather than painful contributions that do raise saving.

A second perspective on advertising is provided by the recent avalanche of ads for mutual funds and the accompanying massive inflows into those funds. Figure 1 shows that as mutual funds have increased dramatically in recent years, personal saving has not. Figure 2 shows that the increase in mutual fund saving has been matched by a decline in individual holdings of equities and bonds. That is, to a large extent households appear to have shifted their assets from one form to another. This is in no way a criticism of the mutual fund industry, which is supplying a product that the public demands. The point is just that the presence of massive advertising does not imply that the subsequent contributions are new saving.

A similarly unproven assertion is that IRAs created a “culture of saving,” or would have if they had not been curtailed in 1986. To some extent, this notion is based on evidence about the persistence of IRA contributions over time. Households that contributed in one year had a very high probability of contributing in the next

year as well. This led to speculation that IRAs helped people create good saving habits over time (Skinner 1992, Thaler 1994). The problem with this conclusion is that the data on persistence are perfectly consistent with standard models (Engen and Gale 1993). There is nothing surprising about the persistence of contributions over time. A purely rational model with no "habit formation" generates the same persistence as the data.

Moreover, other evidence makes it hard to believe that IRAs created a culture of saving. The early 1980s featured lower inflation, lower tax rates, high real interest rates, cuts in social security as well as expanded IRAs, yet the saving rate fell rather than rose during the "golden years of IRAs."

CONCLUSIONS

Expanding targeted tax-based saving incentives is unlikely to raise the saving rate by very much if at all, but could have real costs in terms of tax, budget and retirement income policy. Excessive focus on tinkering with tax-based saving incentives obscures other possibilities for raising private and national saving. The surest way to raise national saving is to reduce the budget deficit in ways that do not reduce private saving.

Raising private saving may prove more difficult, but several options are worth exploring. The most obvious candidate is improved financial education of workers. There is serious concern that a substantial fraction of the population will not be adequately prepared for retirement. At the same time, however, a large proportion of households do not use the saving incentives that are already available to them. Everyone, for example, can contribute to an IRA or a fixed or variable annuity if they so choose and receive a tax-preference relative to other saving. Only about two-thirds of workers eligible for 401(k) plans actually participate. Improved education would also be worthwhile to provide needed assistance to American households as the pension system moves away from defined benefit plans and toward defined contribution plans, which place more responsibility on workers, and as social security reform is considered.

Another fruitful area of reform in my view is pension legislation. An improved pension system would feature enhanced pension coverage, simplified nondiscrimination rules with a higher minimum contribution, higher maximum contribution limits, and removal of taxes on excess payouts and excess accumulations.

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Table 1. Decomposition of U.S. Personal Saving, 1971-93

Percent of net national product				
Type of saving	1971-80	1981-85	1986-90	1991-93
Net personal saving	7.2	8.1	5.8	5.9
Retirement	3.7	6.7	5.7	5.6
Pensions	3.7	5.4	4.4	4.2
Individual	n.a.	1.3	1.3	1.4
Life Insurance	0.5	0.3	0.6	0.5
Other	3.0	1.1	-0.5	-0.2

Source: Sabelhaus (1996).

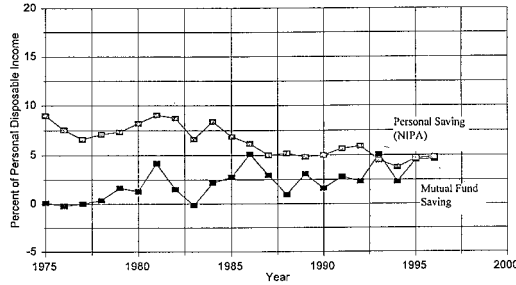
Table 2. Characteristics of Households with and without IRAs, 1986

	All Households	Households without IRAs	Households with IRAs	Households that contributed to the Limit 3 years in a row
Age	49	49	50	51
Annual Income	\$21,320	\$15,667	\$35,000	\$44,500
Non-IRA Financial Assets	\$6,000	\$3,000	\$21,865	\$41,269
Net Worth	\$42,710	\$25,470	\$107,946	\$188,943
Saving (Change in Net Worth, 1983-6)	\$6,129	\$2,884	\$23,500	\$60,691

Source: Gale and Scholz (1994).

Note: All dollar figures are in 1986 dollars.

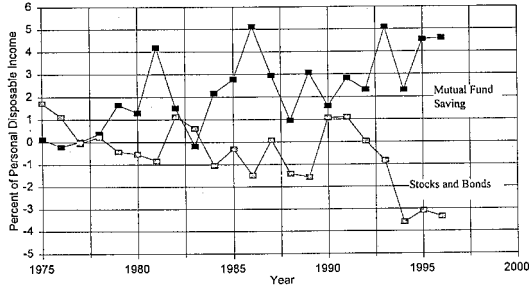
Figure 1. Personal Saving and Saving in Money Market and Mutual Funds, 1975-96



Source: Flow of Funds, Document Z.1, Table F.9; Economic Report of the President 1997, Table B-28.

Note: Mutual fund saving equals shares in money market funds (Table F.9, line 5) plus mutual fund shares (Table F.9, line 14).

Figure 2. Personal Saving in Mutual Funds and Stocks and Bonds, 1975-96



Source: Flow of Funds, Document Z.1, Table F.9; Economic Report of the President 1997, Table B-28.

Note: Mutual fund saving equals shares in money market funds (Table F.9, line 5) plus mutual fund shares (Table F.9, line 14). Saving in stocks and bonds equals the sum of saving in municipal securities (line 11), corporate and foreign bonds (line 12), and corporate equities (line 13).

Chairman ARCHER. Thank you, Dr. Gale.

I can see that my colleague, Mr. Neal, is just ready to jump in and have a debate with you on this, but unfortunately, unless he wants to stay and Chair the Committee while I go vote, we are going to have to recess while both of us can go vote.

Mr. NEAL. Would you offer that to me on a permanent basis, Mr. Chairman?

Chairman ARCHER. I don't think that would play too well.

Mr. NEAL. Well, then we had better go vote.

Chairman ARCHER. Yes.

We will recess temporarily to go vote, and if you don't mind, we will be back in about 5 or—well, maybe 8 or 9 minutes.

[Recess.]

Chairman ARCHER. Could I ask you to take your seats again at the witness table.

Dr. Gale, I was hoping I could conclude my questioning before Mr. Neal got back, but I see that I didn't succeed in doing that. So I guess you still will be engaged by him in a colloquy.

I would like to inquire particularly about what I think I heard Dr. Yakoboski say, which is that today, 89 percent of the single employed people are eligible for IRAs. Did I understand you correctly to say that?

Mr. YAKOBOSKI. That is correct. Of that 89 percent, not all are eligible for the full \$2,000 deduction. Some are only eligible for a partial deduction, but 89 percent are eligible for at least a partial deduction.

Chairman ARCHER. I would like to engage Mr. Higgins, then, because you have suggested that we need a broader application of IRAs in order to increase national savings, but if 89 percent of the people are already eligible, then will we only increase it for 11 percent of the working single people if we accept your suggestion for changes in the IRAs?

Mr. HIGGINS. Mr. Chairman, I think that is a good question. I believe most Americans do not know whether they are, in fact, entitled to a full or partial IRA. There is, I would say, a lack of education. There clearly is a lack of advertising in the post-1986 period on IRAs and the benefits to consumers from IRAs, and that is why we feel quite strongly that we need a simple IRA that every American can understand. We need as an incentive, a tax-deductible contribution, that every American can understand, and it has been my experience in the pre-1986 period that a large percentage of Americans would respond positively to that and would move from consumption to savings if they understood the proposition clearly.

Chairman ARCHER. Thank you.

My colleague, Congressman Bill Thomas from California, because of other commitments, is unable to be here for the hearing today, and he has asked that I submit to you, Mr. Higgins, five questions in writing which may already have been delivered to you, but for the record, I am submitting those to you and we would appreciate your responses in writing.

Mr. HIGGINS. We will respond promptly, Mr. Chairman.

Chairman ARCHER. All right. Thank you very much.

[The followup answers were subsequently submitted by Mr. Higgins to Congressman Thomas.]


Securities Industry Association

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Answers to questions for James F. Higgins,
 Chairman, Securities Industry Association Board of Directors
 submitted for the record by Congressman Bill Thomas
 March 19, 1997

1) How many taxpayers who could make deductible contributions to an IRA fail to recognize their eligibility for deductions today?

There has been a dramatic fall-off in contributions to IRAs following the "Tax Reform Act of 1986." As expected, taxpayers who no longer qualified for the deduction ceased contributing. In addition, IRA participation fell by nearly 40% among households that were eligible for full deductibility.

A 1993 Employee Benefit Research Institute ("EBRI") survey estimates that

- of the 89% of all single workers eligible to make a tax deductible IRA contribution, only 5% contributed.

- of the 56% of dual earner married couples eligible to make a deductible IRA contribution, 10% chose to do so. And,

- among the 82% of eligible single earner married couples, 9% made an IRA contribution.

The most likely explanation for this behavior is either that reduced marketing and promotion of these accounts has reduced consumer awareness or that the eligibility rules are complex and therefore are misunderstood by consumers.

2) Some securities firms have done market research to learn what consumers want as an incentive to save. Can you comment on those findings?

My firm, Dean Witter Reynolds, Inc., commissioned the Opinion Research Corporation in 1995 to survey our clients on retirement issues. Our survey results indicated that 68% of our clients believe that current tax laws do not encourage enough savings and that changes in the law would enhance their retirement savings behavior.

The primary reason cited for not contributing to an IRA today is the lack of tax-advantages for doing so. When presented with proposals to provide incentives to save, our clients' response was overwhelmingly positive. For example, "restoring the universal availability of the fully tax-deductible IRA, regardless of income," was viewed as important by three quarters of our clients and it is the one change that would stimulate a majority of clients (61%) to actually contribute to an IRA.

In addition...

- 69% of all clients felt allowing qualified penalty-free early withdrawals was an important change. 46% indicated they would be more likely to contribute to an IRA with this feature.

- 66% indicated that permitting earnings to be tax-free when withdrawn was very important - and, 42% said they would be more likely to contribute to an IRA with this feature.

- 38% of married clients said they would be more likely to contribute to an IRA if the spousal contribution limits were increased.

Research conducted by securities firms have generated similar findings.

3) Why is the investment community unable to convince people to take out IRAs today?

There are several reasons. First, as the Dean Witter Survey indicates, taxpayers are reluctant to contribute today because there is no tax-advantage to doing so. Second, the eligibility rules for IRAs are complex and can be misunderstood by consumers.

4) How hard is it to get people to open and put money in today's IRAs when taxpayers are told about income limits and early withdrawal penalties?

It is very difficult to convince consumers to save when the savings vehicle is complex to understand and restrictive in its use.

5) The President's proposal appears to end the IRA expansion in 2000. It also imposes higher income limits on deductions. Given your experience, will termination of benefits discourage contributions and opening of accounts? Do you think the income limits or deductions can be set high enough to entice people to save?

In order for the IRA to have a long term positive impact on individual saving, the proposal should not sunset in 2000. Since our experience shows that complex eligibility requirements discourage individuals from contributing to an IRA, we prefer no income limits and encourage Congress to support universal availability of fully deductible IRAs.

Let me ask all of you, have you had an opportunity to look at the entire Clinton budget proposal relative to taxation? Have all four of you had a chance to do that? Have you only looked at the IRA provisions?

Mr. GALE. The whole thing.

Mr. HIGGINS. The whole thing.

Mr. YAKOBOSKI. I have just looked at the IRA provisions.

Chairman ARCHER. Only at the IRA provisions.

I wanted to get your input as to what you thought overall of the Clinton tax proposals, relative to savings and investment.

Mr. THAYER. Mr. Chairman, we have looked at it, and in general, I think we would support greater tax relief than what is there right now.

Our members, in general, in most of the surveys we have had of them, have obviously gone right to that—wanting more tax relief. We think the budget as it stands right now does not go forward enough, and that would be the one thing we would submit here today.

Chairman ARCHER. Well, what can you isolate in the Clinton proposals that does impact favorably on savings and investment?

Mr. THAYER. Excuse me for consulting with my tax consultant there. The issue is really—

Chairman ARCHER. As long as we have this code, you have to do that.

Mr. THAYER. You have got to do that sometimes. That is right.

This goes directly to those issues that you are very familiar with and we have talked about before. Of course, that is the self-employed deduction of the health insurance and other tax issues that we have lobbied long and hard for, as you very well know.

We also sent a letter over to the White House asking that there be some tax relief for the self-employed and that the home office deduction be included in the budget package itself.

Obviously, we didn't get that, but that would make life a lot easier for us.

Chairman ARCHER. What did you get in the Clinton budget package?

Mr. THAYER. I am still looking. We really are still looking. We didn't get that much, and that is what we are saying. The self-employed community really would have liked to have seen some specific relief like the self-employed health insurance deduction, the home office deduction, obviously pension relief. We could have used more there. We didn't see that. So that is why we have come at it from a different route, as you very well know, Chairman Archer, thanks to many of the things you have joined us on.

Chairman ARCHER. Thank you.

Mr. Higgins, Have you had a chance to evaluate the savings and investment provisions in the President's budget, and if so, What is in there that you particularly like? Obviously, it doesn't go far enough from your testimony, but what is in there that you think is positive?

Mr. HIGGINS. Mr. Chairman, the two components that we like most are IRA provisions and capital gains relief, and in the case of IRAs, we think the President's proposal is a step in the right direction, but we think, quite frankly, it falls woefully short of the mark in terms of what will change behavior across the length and breadth of this country as it relates to savings and investment.

Chairman ARCHER. I don't want to put words in your mouth, but what I understand you to have just said is that the President's proposal on IRAs really, in your opinion, will not do anything to significantly improve the savings rate in this country.

Mr. HIGGINS. Mr. Chairman, I would say that the impact will be modest.

Chairman ARCHER. On capital gains, of course, the only thing I can see in this proposal is something on principal residences, and I would assume that that really does not strike at the real need for investment capital to create jobs in this country.

Mr. HIGGINS. That is correct, Mr. Chairman.

Chairman ARCHER. All right. Thank you very much.

Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Higgins, do you believe that carefully designed IRAs will create new savings?

Mr. HIGGINS. Yes, I do.

Mr. NEAL. Would you elaborate on that?

Mr. HIGGINS. Congressman, I believe the IRA account, as we knew it prior to 1986, was a proposition that most, if not all, Americans understood, and the features of the immediate tax deductibility, coupled with tax-deferred gains, is a proposition that was effective pre-1986 and will be, if enacted, extremely effective going forward and should have a meaningful effect on increasing savings rates in this country.

Mr. NEAL. How do you respond to the suggestion in some quarters that the IRA will only benefit the wealthy classes as opposed to the middle class?

Mr. HIGGINS. Congressman Neal, I can only relate to some surveys, some data that I have seen over the years that indicate the primary beneficiaries are what I would call middle-class Americans, not the wealthy, and I would say from my own experience, our accounts at Dean Witter and Co. who have IRA accounts have balances that average about \$20,000 and incomes that are less than \$100,000.

Mr. NEAL. Mr. Thayer, do you believe that IRAs will create new savings?

Mr. THAYER. Do I believe—I am sorry?

Mr. NEAL. Do you believe that IRAs will create new savings if carefully designed?

Mr. THAYER. I certainly do if they are more universal. Let me talk about what you just alluded to, Congressman, when you talked about them being just for the rich.

As you and I know, frankly, \$2,000 isn't too much for a rich person, but even if it was, the benefits of making IRAs universal far outweigh, as far as I am concerned, the disadvantages.

Let us take the self-employed people. We often experience large income fluctuations from year to year, and it isn't fair and it isn't

good economic policy to say to us that in the good years, you can save money in an IRA, but in the bad years, you can't. So we certainly believe that expanding it universally would increase those people saving in America.

Mr. NEAL. OK, thank you.

Now, Mr. Gale, Do you think we can ever have meaningful entitlement reform without offering some incentives to citizens as it relates to the national savings rate?

Mr. GALE. I think entitlement reform is a good idea. I think raising the saving rate is a good idea.

I would submit to you that establishing a new IRA is establishing a new entitlement. It is establishing the entitlement on the tax side rather than on the spending side, but it is an entitlement, nonetheless, and the entitlement would go to anyone that had enough money to put funds in the account.

If IRAs required you to actually save, then they could be more accurately called the saving incentive, but as long as you don't have to save, you don't have to reduce your consumption to get the tax break associated with an IRA, then IRAs essentially are an entitlement, and creating new entitlements makes the entitlement problem worse.

Mr. NEAL. Do you think a carefully designed IRA might overcome some of the objections that you have raised?

Mr. GALE. It depends on what you mean by that. If you mean an IRA that you cannot finance by borrowing money and putting the money in the IRA, that you cannot finance by shifting already-existing assets or current saving into an IRA, then the answer is yes, but then, the question is how do you design an IRA like that. I know of no one who has been able to come up with such an animal.

Mr. NEAL. So you are concerned about what might become kind of a Christmas club effect?

Mr. GALE. Pardon me?

Mr. NEAL. Put it in, take it out, put it in, take it out, is that something that troubles you?

Mr. GALE. What troubles me most is the ability to put it in, put the money in without sacrificing consumption.

Mr. NEAL. Mr. Chairman, I know that the caution light is on. The only thing I would suggest is that the term that has been so popular around here now for the last 3 or 4 years has been the term "personal responsibility," and it seems to me this is an opportunity for us to speak to that issue of personal responsibility, and if we are to proceed down the road to some sort of meaningful discussion about entitlement reform and the national savings rate, that these are the kinds of vehicles that we are going to have to put before the entire membership of the House and hope that good sense will prevail and that we might restore some of these incentives for addressing what Alan Greenspan has suggested time and again. It is the number one economic problem that faces the Nation, and that is our low national savings rate.

Chairman ARCHER. Thank you, Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Rangel, do you care to inquire?

Mr. RANGEL. No. I just want to thank the witnesses, Mr. Chairman, for their comments on a policy option that is very, very popular here, and of course, is quite controversial as to whether it increases savings.

One thing that this Committee has to consider is, How much does any policy cost, no matter how good any program is, or how much revenue does it bring in.

So having the expert testimony of these witnesses and being able to read it will be of great help to me and the rest of the Committee. Thank you for your time and effort.

Chairman ARCHER. My compliments to all four of you. I think it has been an exceedingly interesting exchange of two different viewpoints, and that is what we need to hear before the Committee as we make our decisions. We appreciate your testimony, and you are excused.

The Committee will stand in recess while we vote, and I am told that there will be another, maybe, 15 minutes after this vote before we can reconvene for our last panel, but we will be back as soon as we can get away from the House.

Thank you very much, gentlemen.

Mr. GALE. Thank you, Mr. Chairman.

[Recess.]

Chairman ARCHER. The Committee will come to order, and our next panel of witnesses are invited to take seats behind the witness table.

Our first witness is Martin Regalia—or Dr. Martin Regalia. My apologies.

Welcome to the Committee. If you will identify yourself for the record, we will be pleased to receive your testimony.

**STATEMENT OF MARTIN A. REGALIA, PH.D., VICE PRESIDENT
AND CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE**

Mr. REGALIA. I will do so. My name is Martin Regalia, and I am vice president for economic policy at the U.S. Chamber of Commerce.

We appreciate the opportunity today to come and voice our opinion and give you our views on the savings and investment provisions contained in President Clinton's fiscal year 1998 budget proposal.

The Chamber believes that public policy should not only improve our current economic environment, but also ensure our economic prosperity in the future, and the key to this future economic prosperity really is productivity growth.

Virtually, all economists agree that increases in productivity growth will require savings and investment in capital, both human capital and physical capital, and we further believe that government policies can play an important role in this capital formation.

To boost productivity, the Federal Government must end its misdirection of resources and curb its appetite for borrowing. In addition to balancing the budget, other policy prescriptions include overhauling our regulatory and tort systems, enhancing education, job training programs, and most importantly, reducing the tax burden while reforming the Tax Code.

Measured against this criteria, we find the President's fiscal year 1998 budget proposals to be a major disappointment. Fundamental problems are left unaddressed, real spending cuts are delayed, so-called tax cuts are offset by other tax increases and tax triggers, and budgetary legerdemain is still required for the budget to even come close to balancing. Long-term economic growth appears to be a lower priority than continuing business as usual in the Federal Government.

Focusing primarily on the tax aspects, the U.S. Chamber believes that to increase national savings and investment, substantive policy reforms must be made to the estate and gift tax, to individual retirement accounts, to the capital gains tax, and to the alternative minimum tax.

The Federal estate and gift tax system, or the death tax as many refer to it, is a major source of our Tax Code's bias against savings and investment. The estate tax penalizes those who have saved and invested for their entire lives, and the confiscatory nature of this tax clearly discourages entrepreneurship, job creation, capital formation, and can in extreme cases contribute to the demise of family businesses.

Ongoing businesses have no choice but to expend large amounts of their financial and human resources on complicated estate tax planning and tax compliance services. This is why we believe the best approach to relieve small businesses from the burdensome and ineffective estate tax would be to repeal it outright. Short of that, we believe there are several ways in which the estate tax can be reformed in order to make it less harmful to small businessowners and their workers. These include: Increasing the unified credit, reducing tax rates, and exempting family owned businesses.

By virtually any measure, savings in the United States has declined in recent decades. The ominous shortfall over such a long period of time imperils our economic future because saving funds the investment needed for future growth.

We believe one way to encourage higher personal savings would be through the expansion of individual retirement accounts. The Chamber believes that IRAs should be expanded as broadly as possible in order to give individuals additional incentives to save, and we believe that increasing the deductible contribution amount, repealing the active participant rule between spouses, permitting penalty-free withdrawals for qualified purposes, and creating new backloaded IRAs would all help in this regard.

A vibrant healthy economy also requires that resources be allocated to their most efficient and productive uses, but high tax rates on capital gains impose a barrier to the efficient flow of capital.

Capital gains tax reform would spur investment activity, create jobs, and expand the economy, which would benefit individuals of all income levels.

We believe that reducing capital gains rates on individuals and corporations, indexing the basis of capital assets for inflation, providing capital loss treatment for sales of principal residences, and expanding the preferential capital gains treatment for small business stock would all work toward increasing the amount of investment and savings in this country.

Originally envisioned as a method to ensure that all taxpayers pay a minimum amount of tax, the AMT has become unfair and penalizes businesses that heavily invest in plant, machinery, equipment, and other assets. The AMT significantly increases the cost of capital and discourages investment in productivity-enhancing assets by negating many of the capital formation incentives provided under the regular tax system, most notably accelerated depreciation. In fact, the AMT cost recovery system is the worst among industrialized nations and places our businesses at a competitive disadvantage internationally.

As with the Federal estate and gift tax, the best way to provide individuals and corporations with relief from AMT would be to repeal it altogether. Short of that, however, the AMT should be substantially reformed in order to reduce the harmful effects it imposes on businesses. Such reforms include conforming the AMT depreciation rules with the regular tax depreciation rules, allowing taxpayers to offset their current year AMT liabilities with their accumulated minimum tax credits, and making the AMT system less complicated and easier to comply with.

Our long-term economic health depends upon sound economic and tax policies. Today, we are critically shortchanging ourselves and, more importantly, our children as we commit too many of our scarce resources to current consumption and away from prudent investment. Our tax system encourages waste, retards savings, and punishes capital formation, all to the detriment of long-term economic growth. As we prepare for the economic challenges of the next century, we must orient our current fiscal policies in a way that encourage more savings, more investment, more productivity growth, and ultimately, more economic growth.

Thank you.

[The prepared statement follows:]

**Statement of Martin A. Regalia, Ph.D. Vice President and Chief Economist,
U.S. Chamber of Commerce**

The U.S. Chamber of Commerce appreciates this opportunity to express our views on the savings and investment provisions contained in President Clinton's Fiscal Year 1998 budget proposal. The U.S. Chamber is the world's largest business federation, representing an underlying membership of more than three million businesses and organizations of every size, sector and region. This breadth of membership places the Chamber in a unique position to speak for the business community.

INTRODUCTION

The Chamber believes that public policies should not only improve our current economic environment but also ensure our future prosperity. The key to a stronger economic future is simple to define but difficult to achieve: a high rate of economic growth. It's strong economic growth that will allow us to maintain our position of world leadership, increase our domestic standard of living, and meet the daunting demographic challenges that will begin to present themselves early in the next century.

But economic growth does not occur by accident. Just as our farmers do not rely on good luck for bountiful harvests, neither can we rely on chance or the momentum of the past to propel us in the future. The seeds of tomorrow's economic success must be planted today, and so, when evaluating economic policies, we must ask how they would cultivate long-term economic growth.

By definition, economic growth is simply the product of growth in the labor force (i.e., the number of hours worked) and growth in productivity (i.e., output per hour). With growth in hours worked largely determined by demographics, sensible economic policy must emphasize strong productivity growth.

This is a crucial issue because productivity growth has been languishing for the past quarter-century or so. After expanding at a healthy 2.7 percent rate during the 1960's, for example, productivity growth has slowed to an anemic 1 percent rate so far in the 1990's. With growth in hours worked hovering a little below 1.5 percent, long-term economic growth is thus limited to 2.5 percent—well below the average of the post-World War II era.

While measurement problems related to productivity have expanded with the growing share of the economy devoted to service-producers rather than goods-producers, the decline in economic growth over the same period confirms that we are suffering a decline in the underlying growth rate in productivity. The question then becomes: What can we do to raise productivity growth?

Like the farmer who sows the seed corn and cultivates the soil, households and businesses must also prepare for the future. Virtually all economists agree that this is done by saving and investing in capital—both human capital (education) and physical capital (plant and equipment). Thus the issue of long-term productivity growth and, in turn, economic growth becomes one of fostering additions to, and improvements in, capital. Consequently, the U.S. Chamber believes that today's economic policies must be targeted toward improving economic growth by fostering saving, investment, and capital formation. Only through such pro-growth policies can we lay the foundation of prosperity and security for our children into and beyond the 21st century.

To boost productivity, the federal government must end its misdirection of resources and curb its appetite for borrowing so that national savings and investment can be increased. This will yield stronger productivity growth, which in turn will propel the economy on a higher growth track. Besides balancing the budget, other policy elements that would aid long-term economic growth include overhauling our regulatory and tort systems, enhancing education and job training programs, reducing the tax burden, and reforming the tax code.

THE PRESIDENT'S BUDGET

Measured against this criteria, we find that the president's FY1998 budget proposal is a major disappointment. Unfortunately, fundamental problems are left unaddressed, economic assumptions are too optimistic, and budgetary legerdemain is still required for the budget to even come close to balancing. Long-term economic growth appears to be a lower priority than continuing business as usual in the federal government.

We believe that the chief weaknesses of the president's budget are:

Failure to use CBO economic assumptions—After agreeing to use the Congressional Budget Office economic assumptions two years ago as a common starting point, the Administration has again reversed course and used its own Office of Management and Budget numbers. CBO calculates that the Administration will fall \$69 billion short of eliminating the deficit in 2002.

Failure to address entitlement spending—The dramatic growth in Social Security spending is not addressed, and the Administration's Medicare Asolution merely shifts health care costs instead of providing the market incentives that would lower them. The viability of the Medicare Part A trust fund is extended a few more years only by increasing payment responsibility from the trust fund to the general taxpayer.

Establishment of new entitlements—The president has proposed new, embryonic education entitlements that, like earlier entitlements, can be expected to mushroom in cost, expanding the federal government's presence.

Deferral of deficit reduction to the later years—The president's budget treads water for the next four years, saving most of the deficit reduction for the final two years of the plan—after the president is out of office.

Not a path to continued balance in 2003 and beyond—The president's proposal does not establish the groundwork for maintaining a balanced budget in 2003 and beyond. The proposal relies on one-time budgetary maneuvers that will make balancing the budget even more difficult in later years, further diminishing the chances of faster productivity growth.

Tax increases—Despite the Administration's talk about tax cuts, tax increases are also an integral part of the budget. The advertised \$98 billion in tax cuts is a gross, not net, figure. Over five years, the Clinton plan would provide at most \$22 billion in tax relief.

The tax trigger—The Administration relies on a trigger mechanism in the out years that would repeal many of the proposed tax cuts and impose an across-the-board spending cut against most programs to achieve balance by 2002. However, the trigger may be pulled even if the budget were on target to reach balance. According

to statutory language provided by the Treasury Department to the Joint Committee on Taxation after the budget proposal was released, four of the president's tax-cut provisions (education tax incentives, the child tax credit, expanded IRAs, and brownfield provisions) would expire after 2000 regardless of how close the budget was to its target path to balance by 2002.

SPECIFIC TAX ISSUES

In order to increase national savings and investment, substantive policy reforms must be made to the estate and gift tax, individual retirement accounts (IRAs), the capital gains tax, and the alternative minimum tax (AMT). Each of these is discussed below.

Estate And Gift Tax Reform

The federal estate and gift tax system—or the Death Tax, as many refer to it—is a major source of our tax code's bias against savings and investment. The estate tax confiscates between 37 percent and 55 percent of a family's after-tax savings, thereby penalizing those who have saved and invested their entire lives. The confiscatory nature of this tax clearly discourages entrepreneurship, job creation and capital formation.

A growing economy depends on the ability of small businesses to succeed. The heavy estate tax burden, coupled with the limited amount of liquid assets available to business owners, causes many small businesses to curtail operations, sell income-producing assets, or, in extreme cases, liquidate. In fact, the estate tax can be blamed for being a major contributing factor to the demise of family businesses, which are often not passed down from one generation to the next.

Furthermore, businesses often have no choice but to expend large amounts of their financial and human resources on complicated estate planning and tax compliance services—all for a tax which generates a mere one percent of total federal revenue. In addition, the estate tax is extremely costly for the government to administer.

That is why we believe strongly that the best approach to relieve small businesses from the burdensome and inefficient estate tax would be to repeal it outright. Short of that, however, there are several ways in which the estate tax can be reformed in order to make it less harmful to small business owners and their workers.

First, the unified credit—which currently provides a credit of up to \$192,800 against the estate tax—should be increased. This credit effectively exempts up to \$600,000 of a decedent's lifetime transfers from the estate tax. At a minimum, this credit should be indexed for inflation. If the unified credit had been indexed since 1987 when its current amount was phased-in, it would now effectively exempt up to approximately \$830,000 in lifetime transfers. Second, overall estate tax rates—which effectively begin at 37 percent and rise to a crushing 55 percent—should be significantly reduced. Third, in order to promote prosperity for our nation's family businesses, such businesses should be exempted from the estate tax.

The president's budget, unfortunately, would provide individuals or small businesses with little, or no, estate tax relief. His proposal would merely lower the interest rate on the deferred estate tax liabilities of certain closely held businesses. It would not reduce the underlying estate tax liabilities of these or any other types of businesses.

However, many proposals have been introduced in the 105th Congress which would provide taxpayers with significant estate tax relief. For example, The Family Heritage Preservation Act (S. 75 and H.R. 902)—introduced by Senator Kyl (R-AZ) and Representative Cox (R-CA), respectfully, would simply repeal the federal estate and gift tax altogether.

The American Family Tax Relief Act (S. 2)—introduced by the Senate Republican leadership—would effectively increase the exemption amount from \$600,000 to \$1,000,000 over eight years, exclude the first \$1.5 million in value of a qualified family-owned business interest and 50 percent of any excess value from tax, and extend the maximum period for which federal estate tax installments could be made from 14 to 24 years.

Other relief bills have also been introduced, including those by Senators Lugar (R-IN), McCain (R-AZ) and Dorgan (D-ND) and Representatives Crane (R-IL), Livingston (R-LA), Solomon (R-NY) and Stump (R-AZ), which would either repeal the estate tax, increase the unified credit, reduce estate tax rates, or provide family-owned businesses with tax relief.

Expanded Individual Retirement Accounts

By virtually any measure, savings in the United States has declined in recent decades. This ominous shortfall over such a long period of time imperils our economic

future because savings funds the investment necessary to keep the economy vibrant. One way to encourage higher personal savings would be through the expansion of individual retirement accounts.

The Chamber believes that IRAs should be expanded as broadly as possible in order to give individuals additional incentives to save. Ways in which IRAs should be expanded include removing the income limits on active participants in retirement plans, increasing the deductible contribution amount (at least for inflation), repealing the active participant rule between spouses, permitting penalty-free withdrawals for qualified purposes, and creating new backloaded IRAs.

Furthermore, IRAs should not be made more restrictive or take away from other savings vehicles. For example, the IRA contribution limits should not be coordinated with those of salary reduction plans.

There are several ways in which IRAs can be improved and expanded. First, the existing income limitations that apply to those who are active participants in employer-sponsored retirement plans should be completely removed. Individuals of all income levels should be encouraged to save for their futures.

Second, the active participation rule between spouses should be repealed. Currently, one is treated as an active participant in an employer-provided plan (and therefore subject to the income limits for deductible IRAs) if his or her spouse is such an active participant. This rule should be repealed not only because it serves as a disincentive for couples to save more for retirement, but because it can cause a serious shortfall in savings for those who later divorce and are not participants in a retirement plan.

Third, the deductible IRA contribution amount of \$2,000 should be increased to promote additional savings. At a minimum, the amount should be indexed for inflation. Fourth, penalty-free withdrawals should be permissible for qualified purposes, such as first-time home purchases, higher education, medical expenses, long-term unemployment and start-up business costs. Allowing for such withdrawals to be penalty-free would give individuals greater incentive to establish and put money into their IRAs.

Finally, creating a new vehicle for savings, such as a backloaded IRA, would give individuals an additional option to increase personal savings. Under a backloaded IRA, contributions would not be deductible, but distributions (including earnings) would not be taxable if the account is open for a certain number of years and/or the proceeds are used for a qualified purpose.

The president's proposed budget would gradually double the present-law income limits on deductible IRAs, index the \$2,000 contribution limit for inflation, allow penalty-free withdrawals for special purposes (i.e., first-time home purchases, higher education, qualified medical and long-term unemployment expenses), and create backloaded Special IRA accounts.

Unfortunately, his proposal would maintain the active participant rule between spouses. Therefore, one would continue to be considered an active participant in a retirement plan if his or her spouse is an active participant. In addition, this proposal would coordinate the IRA contribution limits with those of salary reduction plans (i.e., 401(k) plans). The effect of this provision is that the maximum amount individuals could contribute to their salary reduction plans would be reduced by the amount of their IRA contribution.

Several expanded IRA proposals have been introduced so far in the 105th Congress, including The Savings and Investment Incentive Act of 1997 (S. 197 and H.R. 446). Introduced by Senators Roth (R-DE) and Breaux (D-LA) and Representatives Thomas (R-CA) and Neal (D-MA) respectively, these bills would completely phase-out the income limits for deductible IRAs over five-years, index the \$2,000 contribution limit for inflation in \$500 increments, immediately repeal the active participant rule between spouses, allow penalty-free withdrawals for special purposes (i.e., first-time home purchases, higher education, qualified medical and long-term unemployment expenses), and create backloaded IRA PLUS accounts.

Expanded IRA legislation was also included in S. 2, the Senate Republican leadership's The American Family Tax Relief Act. This bill would completely phase-out the income limits for deductible IRAs over five-years, immediately repeal the active participant rule between spouses, allow withdrawals free of income tax and penalties for special purposes (i.e., business start-up expenses, long-term unemployment, or higher education), and create backloaded IRA PLUS accounts. Their bill, however, would coordinate the IRA contribution limits with those of salary reduction plans and would not index the \$2,000 contribution limit for inflation.

Capital Gains Tax Reform

Vibrant, healthy economies require resources to be allocated to their most efficient, or productive, uses, but high tax rates on capital gains impose a barrier to

the efficient flow of capital. Lower capital gains taxes would spur investment activity, create jobs and expand the economy, which would benefit individuals of all income levels.

Many investors and businesses are unwilling or unable to sell their capital assets due to the high rate of tax that would be imposed on the gain of such assets—much of which can be due to inflation, rather than real appreciation. This creates a locking effect of capital assets which prevents investors and businesses from allocating their resources to more productive capital or business ventures. Scarce capital, therefore, remains tied up in suboptimal uses, to the detriment of economic growth.

Bold capital gains reforms should be implemented to boost capital formation and mobility. These reforms include reducing capital gains rates on individuals and corporations, indexing the bases of capital assets for inflation, providing capital loss treatment for sales of principal residences and expanding the preferential capital gains treatment for small business stock.

Under the president's budget proposal, a taxpayer would generally be able to exclude up to \$250,000 (\$500,000 if married filing a joint return) of capital gain realized on the sale or exchange of a principal residence every two years. No other capital gains provisions were included in his package. As a result, the president would not provide substantial capital gains tax relief to individuals, and none to businesses. Furthermore, only a small number of homeowners would benefit from the president's provision since most homeowners currently do not pay tax on their home sales due to the tax code's rollover provisions and \$125,000 exclusion for those age 55 or older.

Several bills, however, have been introduced in the 105th Congress which would provide broader capital gains relief. For example, S. 2, the Senate Republican leadership's tax bill, would permit individuals to exclude 50 percent of their net capital gains from tax, subject corporations to a maximum capital gains tax rate of 28 percent, permit certain taxpayers to index certain capital assets for inflation, allow taxpayers to treat losses on the sales of principal residences as deductible capital losses, rather than nondeductible personal losses, and modify rules relating to sales of certain small business stock.

The Capital Formation Act of 1997 (S. 66)—introduced by Senators Hatch (R-UT) and Lieberman (D-CT)—would permit individuals to exclude 50 percent of their net capital gains from tax, subject corporations to a maximum capital gains rate of 25 percent and modify the rules relating to sales of certain small business stock.

In addition, The Capital Gains Reform Act of 1997 (S. 72)—introduced by Senator Kyl (R-AZ)—would provide individuals with a 70 percent capital gains exclusion and corporations with a maximum capital gains tax rate of 22 percent. Another bill, S. 306, introduced by Senator Ford (D-KY), would reduce the current 28 percent individual maximum capital gains tax rate for assets held more than two years on a sliding scale down to a 14 percent maximum rate for assets held more than eight years.

The Chamber believes that substantive capital gains reform is needed in order to spur business investment and productivity growth. Short of repeal, capital gains rates should be reduced for both individuals and corporations, capital assets should be indexed for inflation, and losses on principal residences should be treated as deductible capital losses.

Alternative Minimum Tax Reform

Originally envisioned as a method to ensure that all taxpayers pay a minimum amount of taxes, the AMT had become unfair and penalizes businesses that invest heavily in plant, machinery, equipment and other assets. The AMT significantly increases the cost of capital and discourages investment in productivity-enhancing assets by negating many of the capital formation incentives provided under the regular tax system, most notably accelerated depreciation. In fact, the AMT cost-recovery system is the worst among industrialized nations, placing our businesses at a competitive disadvantage internationally.

To make matters worse, many capital-intensive businesses are perpetually trapped in AMT as they are unable to utilize their suspended AMT credits. The AMT is essentially a prepayment of tax which is substantially unrecoverable for many taxpayers. Furthermore, the AMT is extremely complex, burdensome and expensive to comply with. Even businesses not subject to the AMT must go through the time and expense of AMT calculations.

As with the federal estate and gift tax, the best way to provide individuals and corporations with relief from the AMT would be to repeal it altogether. Short of that, however, the AMT should be substantially reformed in order to reduce the harmful effects it imposes on businesses. Such reforms include conforming the AMT depreciation rules with the regular tax depreciation rules, allowing taxpayers to off-

set their current year AMT liabilities with their accumulated minimum tax credits, and making the AMT system less complicated and easier to comply with.

Unfortunately, the president has not offered any AMT reform proposals in his budget plan. However, several reform bills have been introduced in the 105th Congress which would repeal or reform the AMT. For example, The Corporate Tax Equity Act (S. 73)—introduced by Senator Kyl (R-AZ)—would repeal the corporate AMT.

In addition, Senators Nickles (R-OK) and Rockefeller (D-WV) will soon be introducing legislation which would repeal the depreciation adjustment for both individuals and corporations, and allow taxpayers with accumulated minimum tax credits at least five years old to use a portion of those credits to offset up to 50 percent of their current year AMT liability.

The Chamber believes that the individual and corporate AMT should be repealed in order to spur capital investment in the business community and make our nation's businesses more competitive in the global marketplace. To the extent repeal is not feasible, significant reforms—such as eliminating the depreciation adjustment and allowing taxpayers to utilize accumulated minimum tax credits—should be implemented in order to make the tax less harmful.

CONCLUSION

Our long-term economic health depends upon sound economic and tax policies. Today we are critically shortchanging ourselves and, more importantly, our children as we commit too many of our scarce resources into current consumption and away from prudent investment. Our tax system encourages waste, retards savings, and punishes capital formation—all to the detriment of long-term economic growth. As we prepare for the economic challenges of the next century, we must orient our current fiscal policies in a way that encourages more savings, more investment, more productivity growth, and, ultimately, more economic growth.

The president's budget fails to address these issues, and consequently it perpetuates the present anti-growth policies that have limited productivity for the past 25 years. The U.S. Chamber urges Congress to pass legislation that balances the budget, repeals or at least reforms the estate and gift tax system, expands IRAs, reduces the tax on broad-based capital gains, and eliminates the alternative minimum tax.

Chairman ARCHER. Thank you, Dr. Regalia.

Our next witness is Mark Kalish. Welcome to the Committee, and if you will identify yourself for the record, you may begin your testimony.

STATEMENT OF C. KENT CONINE, OWNER, CONINE RESIDENTIAL GROUP, DALLAS, TEXAS; ON BEHALF OF NATIONAL ASSOCIATION OF HOME BUILDERS; AS PRESENTED BY MARK KALISH, EXECUTIVE VICE PRESIDENT, MICHAEL T. ROSE ASSOCIATES, LAUREL, MARYLAND

Mr. KALISH. Yes, Mr. Chairman. Mr. Chairman, Members of the Committee, my name is Mark Kalish. I am executive vice president of Michael T. Rose Associates. I was also a delegate to the 1994 White House Conference on Small Business. Our company is a builder developer located in Laurel, Maryland. Although Kent Conine from Dallas, Texas, was originally scheduled to testify this morning, he had an unexpected emergency yesterday afternoon and asked me to take his place. So, on behalf of the 190,000 member firms, which employ approximately 7 million people of the National Association of Home Builders, I want to thank you for the opportunity to testify before the Ways and Means Committee today.

At the outset, let me state that NAHB has been a long-time supporter of tax cuts the Committee is discussing today. Even though we support balancing the budget, we hope, Mr. Chairman, that you

will continue your commitment to enact tax cut legislation this year. We are particularly appreciative, Mr. Chairman, of your long-standing support of the broad-based capital gains relief, and we thank you for your continued efforts over the years.

As you know, the home building industry is comprised mostly of small business men and women. Over 50 percent of the national members build less than 10 houses per year. Approximately 15 percent build more than 25 houses per year, and less than 2 percent build over 500 houses per year.

Further, about 80 percent of our members are family owned businesses. Unlike many other industries, homebuilders are affected by all three provisions that you have been addressing today in these hearings. The exclusion of capital gains on the sale of primary residence, the expansion of individual retirement accounts, and the death tax relief, all directly impact the ability of builders to provide affordable housing.

Mr. Chairman, the home building industry plays an instrumental role in our Nation's economy. Housing construction contributes jobs, taxes, and economic activity to the economy. Each year, nearly 3 million jobs are created in the construction of new homes. For every house that is built, 2.4 jobs are created. These jobs create \$98 billion in wages and \$45 billion in Federal, State, and local taxes on those wages and business income.

Even greater economic activity is created as the income is generated in the construction, manufacturing, and sales jobs that are spread throughout the rest of the local economy.

NAHB estimates that housing, including new construction, remodeling, repairing, and maintenance, and the value provided by existing homes account for 13 percent of the U.S. economy. The ongoing benefit provides most American homeowners and renters with decent, safe, affordable housing.

Affordable housing means more Americans can be homeowners, which is an important impact on our society. We should strive to do what is possible to provide the opportunity of home ownership for more young families, and that, Mr. Chairman, is the expansion of the individual retirement accounts, the IRAs, and the penalty-free withdrawal from the IRAs for first-time home purchases will do.

NAHB supports the expansion of tax-deferred retirement savings and the use of IRA deposits for the downpayment on a first home.

The proposal currently before the Committee would create a new IRA and allow penalty-free distribution of funds from that account and from existing IRAs for first-time home purchases. NAHB supports this proposal and suggests modifications to better accomplish its intended purposes.

Specifically, NAHB believes that any legislation should also allow the tax-free withdrawal of funds in addition to penalty-free withdrawals and provide affiliated individuals, such as parents and grandparents, the access to the retirement savings to help a first-time buyer.

Accumulating the downpayment for the purpose of a first-time home is a primary barrier to home ownership for many young households. IRAs could be a useful resource to assist in a first-time home purchase downpayment.

In designating a successful proposal for using retirement funds for downpayment, NAHB believes there are three important components. One, the use must be considered as an alternative investment, rather than a withdrawal. Eligibility must be open to the parents and grandparents of first-time buyers, as well as the buyers. Eligible plans must include IRAs, Keoughs, 401(k)s, other salary reduction plans, and the Federal Government retirement system.

In the alternative, an attractive and economic proposal would allow downpayments for first-time home buyers to be treated as an investment for tax-deferred accounts rather than as penalty-free withdrawals. Withdrawing the funds also subjects the taxpayer to implicit penalties and that the accountholder's investments in tax-deferred assets are reduced.

From the point of withdrawal on, interest of dividends on withdrawing funds will be taxed at current marginal tax rates, again, often higher than those anticipated during retirement.

Treating the downpayment as an alternative investment would avoid both explicit and implicit penalties.

Mr. Chairman, NAHB encourages you to make rules for the IRA use as flexible as possible. For example, if legislation requires that the funds be maintained on deposit at least for 5 years prior to withdrawal, many young people would not be able to take advantage of this legislation. First-time home buyers are typically in their early thirties and currently have small account balances in tax-deferred retirement accounts.

The long waiting period, coupled with the first-time purchasers, are funds deferred and diminish the stimulative impact of the proposal.

Mr. Chairman, now turning to the issue of capital gains relief, NAHB remains committed to a broad-based tax cut in capital gains rate. However, we realize that the purpose of today's hearing is to discuss the targeted cuts contained in President Clinton's fiscal year 1998 budget. Increasing the capital gains exemption for home ownership would increase the incentive to own and to own a larger house. Allowing repeated use of the exemption after each sale would enhance housing as an asset by removing barriers to trading before and after the age of 55, which is the current law.

Allowing a repeal, repeated exemption will also remove significant reporting burdens now required of homeowners. Under current law, a typically elderly homeowner who has moved to a retirement community must calculate capital gains liability by going back to records of the first home purchase and following each successive sale and purchase. The recordkeeping and effort necessary to calculate tax liability is daunting for anybody and all the worst for the individuals who have already paid a lifetime of taxes.

Raising the amount of home appreciation exempt from taxes is also necessary now in order to anticipate future home appreciation that will dilute the value of current one-time exemption levels of \$125,000.

At the current levels of house price appreciation, a typical home buyer in 1997 will see \$265,000 of appreciation in their home-owning lifetime. Increasing the limit now will assure those young

households that they will enjoy the same tax advantages of owning as their parents and grandparents.

Finally, Mr. Chairman, I turn my remarks to the issue of death tax relief. Although the President's budget contains some estate tax relief for closely held businesses, it is minimal and needs to be significantly expanded. The President's proposal does very little to eliminate the estate tax burden on small business and is merely a loan program. Although complete repeal makes the most economic sense, NAHB understands the revenue constraints associated with the appeal. Thus, NAHB believes the best solution would be to raise the exemption level from \$600,000 and reduce the overall estate tax rate.

NAHB looks forward with working with the Ways and Means Committee, as well as the administration, to craft a workable proposal that is passable. Home building is dominated by small firms which very often are family owned and operated. The current estate and tax laws operate to destroy family owned businesses. Although a credit is allowed against estate and gift tax sufficient to allow a taxpayer upon death to transfer up to \$600,000 without paying taxes, this exemption amount has not been raised.

The forced sale of family business is disruptive to the home-building industry and increases the cost of producing housing. Further, building homes and developing subdivisions is a long-term process which many times is interrupted and frozen as part of builder's estate. Creation of affordable housing should not be stalled or curtailed as a result of complicated estate issues or the eventual sale of the business.

For these reasons, NAHB supports estate tax relief. Although complete repeal of the estate tax makes the most economic sense, NAHB also supports a reduction in the current estate tax rate and increasing the current estate tax exemption.

Additionally, NAHB supports legislation to preserve family owned businesses by either repealing the estate tax in general or eliminating it from small family owned businesses. We also understand that Senate Majority Leader Lott, with a group of bipartisan Senators, will be introducing an estate tax bill that takes a step in this direction.

In conclusion, for the reasons stated above, the National Association of Home Builders believes that the tax cut proposal currently being considered by Congress and the administration are important to our Nation's economy and the creation of affordable housing.

Home building creates jobs, both directly and indirectly, as well as fuel our economy.

Again, Mr. Chairman, NAHB thanks you for this opportunity to present our recommendations, and we look forward to working with you, your staff in the coming months as the budget process and tax cut proposals move forward.

I also have a copy of our 1997 legislative tax reform policy which I would like to give to you that has all of our legislative issues, and we have them available for all the Members of the Committee.

[The statement and attachment follow. The entire book, "Building the American Dream," is being retained in the Committee files.]

Statement of C. Kent Conine, Owner, Conine Residential Group, Dallas, Texas; On Behalf of National Association of Home Builders; as Presented by Mark Kalish, Executive Vice President, Michael T. Rose Associates, Laurel, Maryland

Mr. Chairman, members of the committee, my name is Kent Conine and I am a home builder from Dallas, Texas. On behalf of the 190,000 members of the National Association of Home Builders (NAHB), I want to thank you for the opportunity to testify before the Ways and Means Committee today. At the outset, let me state that NAHB has been a long supporter of the tax cuts the Committee is discussing this morning. We are particularly appreciative, Mr. Chairman, of your long-standing support of broad based capital gains relief and we thank you for your continued efforts over the years.

As you know, the home building industry is comprised mostly of small businessmen and women. Over 50 percent of NAHB members build less than 10 houses per year. Approximately 15 percent build more than 25 houses per year and less than two percent build over 500 houses per year. Further, about 80 percent of our members are family owned businesses. Unlike many other industries, home builders are affected by all three of the provisions that have been addressed by this morning's hearing. The exclusion of capital gains on the sale of a primary residence, an expansion of Individual Retirement Accounts and a modification to the estate tax all directly impact the ability of builders to provide affordable housing.

HOUSING—ITS ECONOMIC IMPACT

Housing construction contributes jobs, taxes, and economic activity to the U.S. economy. Each year, nearly 3 million jobs are created in the construction of new homes. These jobs create \$98 billion in wages and \$45 billion in federal, state and local taxes on that wage and business income. Even greater economic activity is created as the income generated in the construction, manufacturing, and sales jobs spread throughout the rest of the local economy.

NAHB estimates that housing, including new construction, remodeling, repairing and maintenance, and the value provided by existing homes accounts for 13 percent of the U.S. economy. The on-going benefit provides most American homeowners and renters with decent, safe affordable housing.

Table 1. Number of Workers Needed to Construct 1,000 Houses and Total Wages by Major Industry

Industry Groups	Single Family		Multifamily	
	No. of full-time jobs (1)	Wages (millions)	No. of full-time jobs (1)	Wages (millions)
All Industries	2,448	\$75.5	1,030	\$31.9
Construction	1,125	34.1	428	13.0
Onsite	957	29.0	376	11.4
Offsite	168	5.1	52	1.6
Other industries	1,323	41.4	602	18.9
Manufacturing	597	20.9	279	9.8
Trade, transportation, and services	675	19.3	304	8.7
Mining and Other	51	1.2	19	0.5

(1) Full-time, year round jobs.

Source: Number of workers: NAHB estimates from Bureau of Labor Statistics surveys of labor inputs in residential construction. Wages: NAHB estimates from Bureau of Economic Analysis data.

Table 2. Tax Revenue Generated from Constructing 1,000 Homes: 1994 U.S. Averages

Tax by Source	Single Family	Multifamily
	(Millions)	(Millions)
Total	\$37.0	\$15.8
Federal Taxes	26.9	11.3
Personal Income Tax	6.9	2.9
Corporate and Business Income Tax	8.4	3.5
Social Security Tax	11.6	4.9
Employee share	5.8	2.4
Employer share	5.8	2.4
State & Local Taxes and Fees	10.1	4.5
State & Local General Sales Taxes	3.3	1.4
State & Local Personal Income Taxes	1.7	0.7
State Corporate and Business Income Taxes	2.1	0.9
Local Real Estate Taxes and Fees (1)	3.0	1.5
Property transfer tax	0.5	0.2
Building permits, approval and impact fees	2.5	1.3

(1) Excludes ongoing local property taxes of \$1.7 million on 1,000 single family homes and \$0.9 million on 1,000 multifamily homes.

Sources: Table II-4, U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income Bulletin, Summer 1994; and U.S. Department of Commerce; Bureau of Economic Analysis, Survey of Current Business, July 1994 and February 1995; U.S. Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism; 1993, Volume I; National Apartment Association and NAHB estimates.

HOME OWNERSHIP—IT'S IMPACT ON OUR SOCIETY

Homeownership truly is a fundamental part of the American Dream. Getting a good education, working hard, practicing thrift so that home ownership can become a reality, has been a motivating force for millions of Americans. NAHB's surveys show that 80 to 90 percent of all Americans want to become home owners. Recent studies by Fannie Mae have demonstrated the goal for home ownership is strong among all age and income groups. Homeownership not only allows families to establish roots in their communities, but it strengthens neighborhoods, expands participation in civic, religious, and community activities—it is what ties our neighborhoods together.

Financial security is another benefit of homeownership. A home is the largest single asset of most Americans. For millions it represents a nest egg for retirement which has provided the elderly a strong supplement to social security. Many point to the low rate of per capital savings in the United States. However, if the equity in the homes of individuals were calculated, our per capita savings rates would be dramatically higher.

The tax base for our public schools and community services results from homeownership. It provides a safe haven, a sanctuary, a secure place for families to live, grow and prosper. This environment is essential for the development and growth of our children. How can a child study properly, develop family values, excel and expand their goals and dreams without the proper environment? Homes are what provide that secure, protected and nurturing environment for millions of Americans. We should strive to do what is possible to provide the opportunity of homeownership for more young families, and that Mr. Chairman is what expansion of Individual Retirement Accounts (IRAs) and the penalty free withdrawal from IRAs for first time home purchases will do.

EXPANSION OF INDIVIDUAL RETIREMENT ACCOUNTS

NAHB supports expansion of tax-deferred retirement savings and use of IRA deposits for down payment on a first home. The proposal currently before the committee would create a new IRA, and allow the penalty-free distribution of funds from that account and from existing IRAs for first-time home purchase. NAHB supports this proposal and suggests modifications to better accomplish its stated purposes. Specifically, NAHB believes that any legislation should also allow the tax free withdrawal of funds in addition to penalty free withdrawal and affiliated individuals (e.g. parents and grandparents) should be allowed access to retirement savings for a first-time home buyer.

Accumulating the down payment for the purchase of a first home is the primary barrier to home ownership for many young households. Even with lower down payment requirements under FHA and special affordable housing programs from Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System, first-time

homebuyers find it difficult to accumulate the cash necessary to make the leap into homeownership. The U.S. Census bureau and the Harvard Joint Center for Housing Studies have reported that down payment remains a serious barrier to home ownership for young renters.¹ Approximately nine-out-of-ten young renters cannot afford to purchase even a modest home in their area.

Increasing housing costs add to the housing affordability problem in this country. From World War II until 1980 home ownership rates in the U.S. increased. Since that time home ownership rates overall has declined. Particularly hard hit are those in the prime home buying age of 25–34. The home ownership rates of those in the age group 25–29 dropped from 43.1% to 34.4% and those in the 30–34 age group dropped from 62.2% to 53.1%. This trend is of significant concern.

Table 3. Homeownership Rates (Percent)

Age Group	75	80	85	90	94	95
<25	20.4	21.3	17.0	15.7	14.9	15.9
25–29	43.1	43.3	37.4	35.2	34.1	34.4
30–34	62.2	61.1	53.8	51.8	50.6	53.1
35–39	69.0	70.9	65.3	63.0	61.2	62.1
40–44	73.9	74.2	71.2	69.9	68.2	68.6
45–54	77.0	77.6	75.4	74.9	74.9	74.8
55–64	77.0	79.2	79.2	79.3	79.3	79.5
65–74	71.8	75.2	77.8	79.3	80.4	80.9
75+	67.3	67.8	69.2	72.3	73.5	74.6
All	64.7	65.6	63.9	63.9	64.0	64.7

There are many factors that contribute to the housing affordability problem we are facing in this country. Certainly a factor has been increasing housing costs. Higher mortgage interest rates and general economic inflation have also been factors. The National Association of Home Builders believes that government over-regulation is a significant contributor to increased land development and housing costs. The Kemp Commission on Removing Barriers to Affordable Housing identified numerous government regulations that add to the problem. We strongly urge Congress to make an aggressive review of these regulations and eliminate or change those that are unnecessary, costly and counter productive.

NAHB urges Congress to pass legislation expanding IRAs to create an incentive which will promote savings and encourage homeownership. Mr. Chairman, this proposal will make it possible for thousands of young working families to obtain the American Dream of home ownership. In turn, the construction of their homes will create jobs and the expansion of our economy. Equally important the expansion of homeownership contributes to the social/political stability of our society.

IRA Savings for a Downpayment

IRAs could be a useful resource to assist in first-time home purchase. IRAs already have substantial deposits. Total assets held in IRAs and Keogh plans (retirement plans for the self-employed) reached \$773 billion at the end of 1992. Another \$230 billion is invested in salary reduction plans (401(k), 457 and 403(b) tax deferred employer and employee contribution retirement plans) and \$304 billion is invested in the federal government retirement plan for civil servants.² Collectively, these retirement plans could provide up to 1.3 trillion dollars.

A number of proposals have been made to increase the potential use of retirement accounts for first time home purchase down payments. Proposals for use of existing front-end accounts typically propose penalty-free withdrawals of funds from the IRA for specified purposes. However, the tax that was deferred when the deposit was originally made must be paid at the time of withdrawal. Accordingly, withdrawal would be relatively expensive, especially if the funds were deposited at a time when the taxpayer's marginal tax rate was lower.

To this end, the Savings and Investment Incentive Act of 1997, S. 197, introduced by Senators William Roth (R-DE) and John Breaux (D-LA) in the Senate and the House companion bill sponsored by Representative Bill Thomas (R-CA), restores the IRA deduction and adjusts the \$2,000 deductible amount for inflation. It would also

¹The State of the Nation's Housing 1993. Joint Center for Housing Studies of Harvard University and Who Can Afford to Buy in House in 1991. Current Housing Reports H121/93-3. Bureau of the Census.

²Employee Benefit Research Institute, EBRI Notes, November 1993 and Issue Brief, December 1993.

create nondeductible tax-free IRAs called IRA Plus accounts. Under the provisions of S. 197, distributions may be made free of penalty if used for first-time home purchase by the individual, their spouse, child, grandchild or ancestor. NAHB urges the Committee to consider these bills as it begins drafting legislation on expanded IRAs.

Mr. Chairman, NAHB encourages you to make the rules for IRA use as flexible as possible. For example, if the legislation requires that the funds be maintained on deposit at least 5 years prior to withdrawal, the impact on home ownership would be minimal. First time home buyers are typically in their early 30s and currently have small account balances in tax-deferred retirement accounts. The long waiting period coupled with the first-time purchaser's paucity of funds defer and diminish the stimulative impact of the proposal. Although with such a rule there would still be an increase in the incentive to save, resulting in greater participation, the likelihood of generating substantial savings is small.

NAHB also suggests that the current proposal be modified to allow home purchase withdrawals to be made from parents' and grandparents' accounts. This modification is important because those very individuals this proposal is targeted to assist, young working families who are recently out of college trying to pay off students loans, or finance a car, have precious little left over for a retirement account.

In designing a successful proposal for using retirement funds for down payments, there are three important components: 1) The use must be considered an alternative investment rather than a withdrawal; 2) Eligibility must be open to parents and grandparents of first time home buyers as well as the buyer; and 3) Eligible plans must include IRAs, Keoghs, 401(k) and other salary reduction plans, and the federal government retirement system. In the alternative, an attractive and economical proposal would allow down payments for first home purchase to be treated as an investment for tax deferred accounts rather than as a penalty-free withdrawal. Withdrawing the funds also subjects the taxpayer to implicit penalties in that the account holder's investments in tax deferred assets are reduced. From the point of withdrawal on, interest on withdrawn funds would be taxed at current marginal tax rates, again often higher than those anticipated during retirement. Treating the down payment as an alternative investment would avoid both explicit and implicit penalties.

The ability to use tax deferred retirement accounts for a down payment must be open to parents and grandparents because few young people have sufficient retirement savings to be useful. Table 1 shows participation rates by age of employee in employer pension plans. Table 2 shows account balances by age for salary reductions plans, chiefly 401(k) plans. Employees between 25 and 30 years old have the lowest participation rate in retirement plans and an average account balance of \$5,185. A 10 percent down payment and associated closing costs on a median priced existing home sold would require cash in the amount of \$13,000.³

On the other hand, the parent of a potential first time home buyer is at least 45 years old, with an average IRA balance of approximately \$16,380. Grandparent IRAs are most likely to have sufficient balances to provide down payment support in that workers between 60 and 64 years old have average IRA balances of \$25,011.

Under current law, IRAs are primarily alternative forms of retirement savings when the savers' employer does not offer a retirement account, the saver is not self-employed, or the saver's income is under \$40,000. About 20 percent of all workers have IRAs compared to 53 percent who participate in some employer pension plan. In order to have any sufficient impact, the first-time home purchase provision should also apply to other retirement accounts.

Expanding the eligible investments of a tax deferred retirement account to include qualified first time home purchase will have very little impact on federal tax receipts in the near term. The transfer of funds across investment opportunities is already a frequent occurrence and has no federal tax implications. The ability to use retirement funds for first time home buyer assistance may increase the desirability of saving in this form, both for potential first time home buyers as well as their parents and grandparents. Any increase in tax deferred in tax deferred savings because of the expanded options would decrease federal tax revenues over a longer period of time as deposits increased.

Therefore, NAHB recommends that such use (by either the buyer, parents or grandparents of the buyer) be deemed an eligible investment of the IRA. Roughly 15 percent of potential first-time home buyers have invested in IRAs and another

³The median existing home sales price for the first half of 1993 was \$106,000 and closing costs for an FHA loan are about 2.5 percent of the mortgage amount. Hence, cash required is \$10,600 for the 10 percent down payment and \$2,456 for closing costs on a 90 percent mortgage plus the 3-percent upfront insurance premium.

9 percent have invested in 401(k) plans.⁴ NAHB estimates that allowing a first-time home buyer's purchase to be a qualified investment within the plan would create 20,000 jobs and generate 36,000 additional home purchases.

CAPITAL GAINS

NAHB supports reinstatement of a capital gains rate differential for real estate and other assets and indexing their basis for inflation. More favorable capital gains treatment would not only encourage purchases of existing properties, but would also encourage investment in new construction. For example, taxation of capital gains at 50% of ordinary income rates would eventually reduce all rents by 5%. This represents a tax cut for the middle class and those struggling to become middle class. Yet another example of why a capital gains tax break is not for the wealthy.

NAHB believes that taxation of assets held for one year or more at a lower rate than ordinary income encourages investment and savings. However, taxation of realized gains on long-held assets at ordinary income rates (i.e. on sale or transfer) reduces the economic incentives to invest in the most efficient, highest return opportunities. Removal of the retardant effect of current law taxation would allow taxpayers to place their capital in the most promising sectors of the economy. More efficient capital flows would create jobs and stimulate the economy. A capital gains tax cut would not benefit only higher income taxpayers. Encouraging investment through reduced taxes on the gains from that investment would create jobs and economic activity at all levels of income.

With respect to real estate, a capital gains preference would increase investors and owners incentives to purchase, rehabilitate and operate rental housing. Part of the total return to investors who own rental housing is property appreciation. The greater the owner's after-tax income from the appreciation portion of their return, the less income required from rents to achieve the same earnings. Reducing capital gains tax rates will reduce residential rents. Since much of the appreciation in housing is due to price inflation, adjusting the gains for inflation will reduce rents even more.

We must insist however, that any capital gains incentive include real estate. Just as real estate serves as the engine to lead the economic recovery, so it must be included in any capital gains reduction in order to maximize the dynamic economic impact of the proposal. Indeed, inclusion of real estate effectively rebuts any argument that a capital gains tax cut would favor only wealthy taxpayers. Mr. Chairman, I know this has been a long standing position of yours.

Depreciation Recapture

There is a technical aspect of the capital gains issue relating to the taxation of business and investment real estate which could have strong negative economic impact on our industry. If, as was considered in 1996 budget talks, depreciation rules are altered so that only gain in excess of depreciable real estate's *original* costs would qualify for a new lower capital gains tax rate, three out of five (60 percent) of investment and business real estate sales would effectively be excluded from a capital gains tax cut. Real estate, therefore, would be disadvantaged vis-a-vis other investments, such as stock, further slowing additional recovery in the nation's still fragile real estate markets.

Depreciation deductions for real estate are intended to reflect the inevitable costs associated with the deterioration of a long-lived structure and its many components, such as the roof, heating, ventilation and air conditioning units, plumbing and electrical fixtures, etc. Sale of real estate for more than its adjusted basis is therefore likely the result of the combination of a number of factors—such as, inflation, appreciation in the value of the underlying land and market conditions.

In 1964, Congress required that a portion of the accelerated depreciation on real property be recaptured as ordinary income. Subsequent amendments to the tax law have required that the entire amount of accelerated depreciation on real property be recaptured as ordinary income. However, any depreciation taken to the extent allowable under the straight-line method is generally not recaptured as ordinary income, but rather creates capital gain.

The theory behind depreciation recapture is that to the extent depreciation allowances reflect real economic depreciation, there is no ordinary-income tax benefit to recapture, only a capital gain. Also, to the extent that depreciation allowances exceed economic depreciation, there is an ordinary-income tax benefit which should be taxed at ordinary-income tax rates.

⁴“Down Payment for Retirement Accounts,”Housing Economics, March 1991.

Changing the current depreciation recapture law for improved real property in the manner that has been discussed by the Treasury department would not sufficiently unlock real estate assets and would seriously disadvantage improved real estate to other investments. To be meaningful, a capital gains tax cut must maintain the current depreciation recapture rules.

*Capital Gains Tax on Home Sales
Roll-over and One-Time Exemption Provisions*

While NAHB remains committed to a broad base cut in the capital gains tax rate, we realize the purpose of this morning's hearing is to discuss the targeted capital gains cut contained in President Clinton's FY1998 budget.

Owning your own home provides a personal satisfaction such as the ability to control your living environment and the feeling of being an integral part of your community. Owning also brings financial gains through appreciation, and tax preferences. One of the tax preferences accorded owning is the ability to postpone and partially or entirely exclude taxation on the appreciation.

The roll-over provisions provide some relief to home owners who wish to trade homes but otherwise may incur a tax liability. The roll-over provisions effectively extend the tax treatment currently accorded tax-deferred retirement accounts to housing. If a taxpayer moves deposits in a retirement account from one asset to another, the activity is not taxed. Since home equity is the single largest asset for most families, equivalent treatment would seem appropriate. Financial and real investments not sheltered in retirement accounts do not enjoy these tax benefits and capital gains tax is normally due when realized. The long-run impact of the proposal enhances housing relative to other investments. To a home owner deciding whether to invest in housing, greater relief from tax on gains in an owned home versus some other asset will tilt the tax decision towards housing.

Magnitudes

There are roughly 65 million home owners currently and most would be likely to incur a tax if they were to sell and buy a less expensive home or decide to rent. After the typical length of stay in one home (15 years), a typical home seller today will have \$60,000 in taxable gain if they do not qualify for the rollover or exemption. However, few do pay capital gains tax for one reason or another. According to 1993 IRS statistics, 150,000 tax payers claimed a taxable gain in the sale of a residence in 1992. About 30,000 had no tax liability, and the remaining 110,000 taxpayers claimed an average of \$17,200 in gain. The federal government collected an estimated \$300 million on these gains.

Estimates have been made regarding the number of home sellers who used the roll-over and the one-time exemption to avoid tax in a particular year. The results have been that only half of all home sellers even file the proper form. Presumably, those that did not file were eligible for deferral and didn't realize they still must file (or they lied to avoid paying tax). Additionally, it is estimated that 62 percent of the gains that are reported are not taxed because the home owner bought or is planning to buy a more expensive home and 33 percent of the gain was subject to the one-time exclusion, leaving 5 percent of the gain taxed. Since these ratios omit the sales not reported, the portion of all gains that is actually taxed is even smaller.

Effect of Change

Increasing the current capital gains exemption for home ownership would increase the incentive to own and to own more house. Allowing repeated use of the exemption after each sale would enhance housing as an asset by removing barriers to trading before and after a certain age (55 under current law). Allowing a repeated exemption will also remove significant reporting burdens now required of home owners. Under current law, a typical elderly home owner who moves to a retirement community must calculate capital gains liability by going back to records of the first home purchased and follow each successive sale and purchase. The record keeping and effort necessary to calculate tax liability is daunting for anyone, and all the worse for an individual who has already paid a lifetime of taxes.

Increasing the amount of capital gains that is exempt from tax will increase home ownership by removing the capital gains reporting burden and by making the financial investment in home owning more attractive than the financial investment in other assets. Raising the amount of home appreciation exempt from tax is also necessary now in order to anticipate future home appreciation that will dilute the value of the current one-time exemption level of \$125,000. At current levels of house price appreciation, typical home buyers in 1997 will see \$265,000 of appreciation in their homeownership lifetime. Increasing the limit now will assure those young households

that they will enjoy the same tax advantages of home owning as their parents and grandparents.

“DEATH TAX” RELIEF

Home building is dominated by small firms which very often are family owned and operated. The current estate and gift tax laws operate to destroy family-owned businesses by imposing a tax upon the inter-generational transfer of the business. Moreover, the economic impact of the tax increases from year to year because of inflation. Under present law, estate and gift taxes of up to 55% are imposed on the value of transfers. Although a credit is allowed against estate and gift taxes sufficient to allow a taxpayer upon death to transfer up to \$600,000 without paying tax, this exemption amount has not been increased since 1987.

Impact on Housing

Eighty percent of home building firms in our country are small family-owned businesses. The current tax treatment that we live under limits the ability for current owners to pass these companies onto their family members. Family businesses should be passed to heirs without tax. Death taxes force family owners to liquidate, sell off at a fraction of market value, or pay dearly in estate planning costs instead of growing their business. Additionally, these taxes make parents reluctant to help their children establish themselves in independent business. This forced sale of the family business is disruptive to the home building industry and increases the cost of producing housing. Further, building homes and developing subdivisions is a long term process which many times is interrupted and frozen as an estates of a builder. Creation of affordable housing should not be stalled or curtailed as a result of a complicated estate issue or the eventual sale of the business.

For these reasons, NAHB supports estate tax relief. Although complete repeal of the estate tax makes the most economic sense, NAHB also supports a reduction in the current estate tax rate and increasing the current estate tax exemption. Additionally, NAHB supports legislation to preserve family-owned business by either repealing the estate tax in general or eliminating it for small family-owned businesses.

Although the President’s budget contains some estate tax relief for closely held businesses, it is minimal and needs to be significantly expanded. His budget proposes to ease the burden of estate taxes on farms and other small businesses, allowing their owners to defer taxes on \$2.5 million of value, up from \$1 million under current law. The deferred taxes could be paid over 14 years at a favorable interest rate. The proposal expands the type of businesses eligible for such treatment by making the form of business organization irrelevant.

The President’s proposal does very little to eliminate the estate tax burden on small business and is merely a loan program. Many other proposals on estate tax relief have also been introduced on the Hill—ranging from complete repeal to an approach similar to the President’s. The best solution would be to raise the exemption level from \$600,000 to \$1 million and reduce the overall estate tax rate. NAHB looks forward to working with the Ways and Means Committee as well as the Administration to craft a workable, passable proposal.

CONCLUSION

For the reasons stated above, the National Association of Home Builders believes that the tax cut proposals currently being considered by the Congress and the Administration are important to our nation’s economy and the creation of affordable housing. Home building creates jobs both directly and indirectly, as well as fuel our economy.

Once again Mr. Chairman, NAHB thanks you for this opportunity to present our recommendations. We look forward to working more closely with you and your staff in the coming months as the budget process and tax cut proposal move forward.

National Association of Home Builders

A. CONTRIBUTIONS-IN-AID OF CONSTRUCTION (CIAC)

Policy

Contributions-in-aid of construction (CIAC) must not be taxable to utilities in the year of receipt.

Background

The 1986 Tax Reform Act (TRA) changed the tax treatment of contributions-in-aid of construction and required utilities to include in their gross taxable income the contributions in the year of the receipt. The Small Business Job Protection Act of 1996 contained a provision which repealed part of the changes made in 1986 with regard to CIAC. Specifically, the newly enacted law restores the tax-free treatment only to CIACs made to public utilities that provide water and sewage services. Therefore, any payments made to a water or sewage utility after June 12, 1996 will not be treated as gross income and thus will not be taxable.

These grossed up CIAC (taxes paid by utilities) are passed on to the ultimate home purchaser by the builder. Prior to 1986, Internal Revenue Code Section 118(a) allowed utilities to exclude contributions received in-aid of construction to be excluded from taxable income. Because of the changes in the TRA of 1986, the buyer pays not only for the capital improvements provided to the utility company, but also the resultant tax. In areas affected, the price of housing has risen as much as \$1,000 to \$2,000 per unit.

Solutions

- Seek and support an amendment to the Tax Reform Act of 1986 to reinstate Internal Revenue Code Section 118 (a) for electric and gas utilities.

B. BUSINESS TAXATION

Policy

Federal income tax liability for businesses should be determined by allowing firms to deduct expenses, reserves and depreciation in the year incurred, and by including income received in that year only. Further, businesses that are organized as limited liability companies (LLC's) or limited partnerships should not be subject to the self-employment tax.

Background

Some rules of the Internal Revenue Service and some tax laws do not permit businesses to deduct business costs in the year in which they occur. Under these circumstances, tax liabilities are determined by amounts that may be larger than the actual resources available to the firm. For instance, under current law a firm cannot deduct the cost of removing an environmental hazard, but rather must capitalize the expense over the life of the project. Requiring cost amortization discourages acquisition, development and subsequent clean-up of environmentally impaired real estate and discourages holding property for sufficient time to plan and develop the property to its full potential. Requiring amortized costs encourages land owners to sell quickly in order to record the cost against income which further delays careful planning and orderly development.

The current method for depreciating capital assets calculates annual depreciation based on the original value of the asset without regard to replacement cost. However, most capital goods, e.g. equipment, buildings and machines, cost more to replace than their original cost because general price inflation pushes up the cost of all goods over time. Environmental restrictions and technological advances make certain components of a building such as heating, ventilation and air conditioning systems (HVAC) obsolete or unusable prior to the applicable recovery period for residential and commercial real estate. Major repairs or replacements of these components often have adverse tax consequences by creating an asset with a recovery period far in excess of its real useful life. Consequently, investors in capital equipment and other long-lasting goods are discouraged from investing. A neutral cost recovery system in the tax code would increase investment in rental housing by making the tax consequences of investing reflect the real world impacts of inflation, the economically useful life of major components, and other factors. Under current rules home building firms that set aside reserves against possible future warranty claims cannot deduct the reserves from income even though the funds are inaccessible until the warranty has expired. On the income side prior to 1986, a taxpayer that sold property on the installment basis was taxed as payments were received. Treating

the income otherwise requires a tax on the entire gain in the year of sale when only a small portion of total sale proceeds may have been received in the year of sale, resulting in a taxpayer being unable to pay the taxes due. The 1986 Tax Reform Act prohibited the use of the installment method for dealer sales of developed lots. As a result, landowners are less likely to sell to builders on an installment basis and seek higher prices to compensate for the extra tax burden. Under this change, developers and home builders also are discouraged from building common infrastructure before the homes are completed. Higher land costs and fewer willing land owner partners in new home building increases the cost of new homes and creates affordability problems for potential home buyers.

Under current law, limited partners currently are exempt from self-employment tax under Section 1042 of the Internal Revenue Code. The IRS has issued proposed regulations that would subject certain limited partners and LLC members to self-employment tax. The Taxpayer Relief Act imposed a moratorium on the issuance of final regulations until July 1, 1998 and the conference report to the new law indicates that the self-employment tax treatment of limited partners and LLC members should be determined by legislation.

Solutions

1. Seek and support legislation to allow an inflation-adjusted depreciation allowance.
2. Seek and support legislation to allow environmental cleanup costs to be deductible by the owner in the year in which they are incurred.
3. Obtain clear ruling from the Treasury Department to allow a current year deduction of the costs for clean up of property that is already contaminated when purchased.
4. Seek and support legislation to repeal the restrictive provisions of the 1986 Tax Reform Act which require reporting income from installment sales before it is received. H Seek and support legislation to amend the Internal Revenue Code to define the term "common infrastructure" to include public use facilities.
5. Seek and support legislation to allow builders to deduct reserves established for future warranty losses.
6. Seek and support legislation to preserve the current treatment of limited partners and LLC members under the self-employment tax.

C. DIFFERENTIAL CAPITAL GAINS TAX

Policy

A capital gains tax rate differential should be reinstated for real estate.

Background

The Taxpayer Relief Act of 1997 reinstated a preferential capital gains rate of 20 percent for capital assets held for eighteen months. Under the new law, however, any gain attributable to depreciation is recaptured and taxed at a 25 percent rate. Gain attributable to real estate investments should be treated the same as gain attributable to the sale of stocks or bonds.

Solution

1. Seek and support legislation re-establishing a lower capital gains rate for gain attributed to recaptured depreciation.
2. Support legislation to increase the amount of capital gains on a primary residence that is exempt from tax and to remove the one-time restriction on use of the exemption.

D. ESTATE AND GIFT TAX TREATMENT

Policy

Family businesses should be passed to heirs without tax.

Background

The recently enacted "Taxpayer Relief Act of 1997" increases the estate tax exemption from the current level of \$600,000 to \$1 million by the year 2006. Additionally, the new law allows an additional \$300,000 exemption for qualified family-owned businesses and farms. The phase-in of these increases in the exemption, however, is too long and should be immediate. Further, the exemption should be indexed for inflation. Currently, the value of your estate over the exemption amount can be taxed at rates as high as 55 percent. Therefore, the overall rate of taxation should also be reduced.

Solutions

1. Seek and support legislation to phase-in more quickly the increase in the estate tax exemption.
2. Seek and support legislation to reduce the overall estate tax rate.

E. FIRST-TIME HOME BUYER DOWN PAYMENTS

Policy

First-time home buyers should be able to use tax-deferred retirement savings accounts to accumulate a down payment.

Background

Current law discourages the use of tax-deferred retirement funds for use in purchasing a home. Distributions from tax-deferred retirement accounts made before age 59 are subject to an additional 10-percent tax. Borrowing from an IRA or use of funds in an Individual Retirement Account (IRA) as security for a loan is treated as a distribution. Allowing an eligible first-time home buyer or an or affiliated individual (e.g., parent) to treat a down payment on a home as alternative investment would increase first-time home buyers' access to down payment funds and increase home ownership opportunities for young families. Alternative forms of tax encouragement for savings exempt the interest earnings and withdrawals from taxation but do not exempt the deposit from taxation. Sometimes referred to as "back-end" or the "American Dream Savings Accounts," this form of savings encouragement also increases potential first-time home buyers' ability to save for a down payment. A "back end" savings account reduces federal tax revenue in the early years of the program less than the current "front-end" method of favoring retirement savings.

Solutions

1. Allow retirement plans of first-time home buyers and their family members to make equity investments in principal residences for the first-time home buyer.
2. Seek and support legislation to increase the current limit on deductible IRA contributions.
3. Restore the deductibility of IRA contributions for all taxpayers.
4. Seek and support legislation to establish a "back-end" tax-favored savings account that would allow for tax-and penalty-free withdrawals for a first home purchase.

Related Issue

Section VI. Issue—Down Payments

F. HOME OWNER DEDUCTIONS

Policy

The home mortgage interest and property tax deductions must be maintained without restriction or limitation.

Background

Deductions for mortgage interest and property tax expenses encourage home ownership and stimulate home building which creates jobs both directly and indirectly, fuels our economy and benefits growth at all government levels with increased taxes and revenues. Further restriction would decrease home ownership, depress housing values, and reduce home construction.

Solution

Insist that Congress maintain full deductibility of home mortgage interest and property taxes.

G. HOME OFFICE DEDUCTION

Policy

Home office expenses should be fully deductible.

Background

Until 1993, home office expenses were fully deductible. The Supreme Court's decision in Commissioner of Internal Revenue Service v. Soliman substantially narrowed the availability of the home office deduction. The ruling unfairly restricts small businesses, especially those in the construction industry.

Disallowing the home office deduction either forces a builder to rent or buy space away from home for the same purpose or use the home as an office, but lose the legitimate expense as a deduction. Either choice increases the cost of doing business without improving the delivery of new homes to buyers. The effect adds cost to new homes and reduces affordability.

Solution

Seek and support legislation that allows the full deduction of home office expenses.

H. INDEPENDENT CONTRACTOR

Policy

Home building contractors should qualify as independent contractors for tax purposes.

Background

The promise and vibrancy of the American economy generally and the home building industry in particular lies in its make up of millions of independent business persons. As a matter of sound public policy, independent contractor businesses should be fostered, and they should not be discriminated against by Internal Revenue Code regulations. The 1996 Small Business Job Protection Act improved the independent contractor safe harbor relief in two respects—by injecting some clarity into the distinction between an independent contractor and an employee, and by putting constraints on the IRS's practice of over aggressive auditing of small business owners using independent contractors. These provisions take effect on September 1, 1997 but do not go far enough in clarifying independent contractor distinctions in the home building industry.

Solution

1. Seek and support legislation to protect independent contractor status and facilitate qualification as such.

Related Issue

Section VII., Issue—B. Health Care

I. LOBBYING TAX DEDUCTION

Policy

Lobbying expenses should be an allowable business expense deduction.

Background

The tax code prohibits the business expense deduction for any amounts paid in an attempt to influence federal or state (but not local) legislation through communication with members or employees of legislative bodies or other government officials who may participate in the formulation of legislation. The code also disallows a deduction for costs of contacting certain high-ranking federal executive branch officials in an attempt to influence their official actions or positions. Trade associations allow their members to learn about their industry and to participate in a complex democratic process through professional staff and volunteer members. This education and participation process provides a public good to the rest of the economy by focusing issues and concerns on the voters most affected. Taxing the dues that support this process retards the democratic process.

Solution

1. Seek and support legislation which allows members of a trade association to deduct lobbying expenses.

J. LOW-INCOME HOUSING TAX CREDIT

Policy

The Low-Income Housing Tax Credit must be maintained to encourage investment in affordable housing.

Background

The Low-Income Housing Tax Credit (LIHTC) and tax-exempt bond financing are the primary vehicles for financing the construction of low-income rental housing. Restrictions on these tax incentives unnecessarily raise the cost of rental units and

subsequently reduce the number of rental units that could be provided to low-income families. The LIHTC provides a critical incentive for the production of affordable rental apartments, and more than 95 percent of affordable units produced for low-and moderate-income households involve the use of this program.

Under the current law, states have an allocation of total credits which can be issued and When the LIHTC was created in 1986 the annual amount of authority for the program was fixed at \$1.25/capita. This annual authority amount has not been increased since 1986 and as a result the number of affordable units produced annually has decreased steadily from a high of 124,500 units in 1989 to 75,000 units last year. The cost of producing affordable housing has increased, but the amount of authority has not.

Further, under current law states are responsible for allocating tax credits to projects, but are restricted to two credit rates, 9 percent and 4 percent. Allowing states to divide their allocation of subsidy in different ways would provide greater local flexibility and provide greater incentives where they are needed without changing the overall federal cost.

Solutions

1. Oppose any efforts to repeal the Low-Income Housing Tax Credit.
2. Seek and support legislation to exempt low-income housing tax credits from the alternative minimum tax.
3. Seek and support modification to existing law to allow states to determine the credit rate.
4. Seek and support legislation to modify the occupancy and income targeting requirements to enhance the use of tax-exempt financing for low-moderate income rental projects.
5. Seek and support legislation to increase the annual amount of authority for the LIHTC to reflect increases in housing production costs and permit the authorized amount to be adjusted annually for inflation.

Related Issues

Section V., Issue—B. Government Support for Affordable Housing
Section V., Issue—D. Housing Finance Agency Programs

K. MORTGAGE REVENUE BOND ELIGIBILITY

Policy

Certification of buyer's eligibility for the mortgage revenue bond program should be made at the time of mortgage application, not at the time of closing.

Background

The proceeds of mortgage revenue bonds (MRBs) are used to finance the purchase, or qualifying rehabilitation or improvement, of single family, owner-occupied residences. Between the time of the original MRB application and closing (when income is certified under the federal rules), the buyer's family income may rise above the MRB income limit making the buyer ineligible for MRB financing. Certification of eligibility so late in the process unfairly harms builders who have paid costs and met their contractual obligations in good faith.

Solutions

1. Urge Congress to preserve the Mortgage Revenue Bond program.
2. Seek and support legislation to modify the current rules to provide for certification of buyers at time of mortgage application.

L. PASSIVE ACTIVITY LOSS RULES

Policy

Private investment in rental projects should be encouraged through the repeal of the passive activity loss tax treatment.

Background

The Tax Reform Act of 1986 discriminated against real estate activity by enacting limitations on the deduction of "passive" activity losses (PAL). The impact of this rule decreased the effective return on all investments in rental housing—for new owners as well as existing owners. The result has been a decrease in the value of existing properties and a decline in investment in new rental housing. Ultimately, as the rental inventory adjusts to the new tax rules, rents will rise to equalize the after-tax returns on investments in rental housing with other investment opportuni-

ties. The 1993 Budget Act removed real estate professionals from the coverage of the PAL rules, but imposed restrictions that allow few owners to benefit from these changes.

Solutions

1. Seek and support legislation to repeal the passive activity loss rules.
2. Urge the Internal Revenue Service to permit grouping rental real estate activity with other builder-related real estate activities.

Like Kind Exchange of Property

Policy

The current rules that allow the tax deferred exchange of like kind property should not be changed.

Background

Under current law, section 1031 of the Internal Revenue Code (IRC) provides for the tax deferred exchange of like kind property. Under this section of the Code an individual may exchange like property and defer recognition of their taxable gain on the property until they accept cash or other payment for the property.

The current definition of "like kind" allows for the exchange of developed property for undeveloped property. There have been legislative proposals to change the definition of "like kind" to "similar use" which would severely curtail many beneficial real estate transactions and reinvestment in communities struggling to improve distressed properties. Further, changing the definition would cause taxpayer uncertainty and create complex new administrative burdens.

Solution

Oppose any proposals to change or limit the definition of "like kind" for the purposes of section 1031 exchange.

M. REHABILITATION

Policy

A rehabilitation tax credit should be available for owner-occupied historic homes.

Background

Under current law, rehabilitation of historic commercial buildings used in a trade or business or rented are eligible for a rehabilitation tax credit. However, owner occupants are not eligible for the credit. Expanding the credit to owner-occupied homes would create incentives to rehabilitate historically significant properties and revitalize older neighborhoods.

Solution

Seek and support an amendment to the Internal Revenue Code to extend the historic rehabilitation tax credit to owner-occupied residences.

Chairman ARCHER. Thank you, Mr. Kalish.

Our last witness in this panel, I would like personally to have the honor to introduce, but I am going to yield to my colleague from New York, Mr. Rangel, for the introduction.

Mr. RANGEL. Bipartisanship at its height.

Let me thank the entire panel for your patience. We have had more activity on the House floor today than we expected. I thank the Chair for giving me the honor of introducing an old friend, Morty Davis. Not only is he a self-made businessman and chairman of the board of D.H. Blair Investment Banking Corp., but he has also spent quite a bit of time trying to reenergize that engine that America depends on, and that is small business. There is hardly a capital gains tax relief program that somehow he has not managed to have his ideas incorporated in. This Committee is privileged to have you to share those views with us today.

Thank you for being here, Morty.

Chairman ARCHER. Mr. Davis, if you will identify yourself for the record, we would be pleased to receive your testimony.

**STATEMENT OF J. MORTON DAVIS, CHAIRMAN OF THE BOARD,
D.H. BLAIR INVESTMENT BANKING CORP., NEW YORK, NEW
YORK**

Mr. DAVIS. I thank you very much, Mr. Chairman. Thank you very much, Congressman Rangel. You are both sensational guys. I love you both, and I think you are doing fabulous jobs. You are both great statesmen.

I am chairman of the board of D.H. Blair Investment Banking Corp. in New York. I am also, incidently, founder, funder, and largest stockholder of your new exciting weekly down here, The Hill. I hope you enjoy it.

Mr. Chairman, Congressman Rangel, and Members of the Committee, I very much appreciate the opportunity to present testimony on the critical issue of how to promote savings and investment.

Mr. Chairman, I am a great admirer of yours. Again, let me repeat that. I am a great admirer of yours and particularly your efforts to reform the present Tax Code which is biased in favor of consumption over savings and investment.

I strongly support your campaign to remove tax barriers to the capital formation needed to fuel economic growth and job creation in our country.

Congressman Rangel, I am also a great admirer of your efforts to ensure that economic growth and job creation, which we all want, include those persons who historically have not shared fully in the American dream.

I am testifying today in support of legislation which I strongly believe would contribute greatly to meeting both your objectives, specifically targeted capital gains tax relief to new and small businesses. This legislation would build the pool of investment capital by deferring taxes on capital gains realized from direct investments in new and small businesses, so long as those gains are reinvested in similar small and new companies.

These tax-deferred rollovers would work much like the tax treatment afforded to those who sell a home and purchase another within a specified period of time or to those who roll over their IRAs or 401(k) plans from one investment to another.

Mr. Chairman, you rightly have called for reform of the Tax Code to promote investment and eliminate the prevailing bias toward consumption. The rollover proposal would do both. The rollover legislation would defer capital gains taxes on an entire class of investments, so as to encourage such productive investments, if, and only if, the initial investment and the gain thereon is promptly reinvested in another new or small business.

By deferring the tax on capital gains from investments in new or small businesses, the market would be incentivized to allocate capital to where it would do the most good. On the other hand, if gains are not promptly reinvested in another new or small company or, instead, used for consumption, then that gain would immediately be taxed.

Congressman Rangel, the rollover proposal would also help achieve your goals. The legislation would ensure that sufficient investment capital is directed to new and small businesses which have proven to be the most potent catalyst for economic development and job growth in distressed urban areas.

Capital spending by small business produces jobs and lots of them. It accounts for almost all of the new jobs. It produces spending for capital equipment and lots of it, and far out of proportion to the dollars invested by large companies, and this is statistically demonstrated, capital spending by small companies produces the most new technologies and exciting discoveries to enhance the quality of our lives and those of our children and our children's children. I must just add, particularly in the new areas of biotech, where we are working on cures for cancer and heart disease and all the things that will enhance the quality of our lives, and particularly, in my case, I am working especially to halt the aging process and even reverse it so we can get even with our kids, be younger than them, but that is the kind of exciting things we are working on and that are so promising for the future.

As an investor, I repeatedly have observed that instead of creating jobs with new capital, the Fortune 500 has been a net loser of jobs, but as soon as a new or small company receives a check, not in 1 year, not in 1 month, but the very next day, it is out hiring new workers, purchasing new capital equipment, and creating almost all of the new jobs and new products. This is true capitalism and true growth enhancement.

Large companies have easy access to capital through banks, commercial paper, and various established private and public markets for their debt and equity securities.

Entrepreneurs and small companies, on the other hand, have no place to go. They have to scramble around for capital and usually often unsuccessfully.

The rollover proposal would help entrepreneurs and new and small businesses get the capital they need. I strongly believe that the small business capital gains rollover proposal is a critical component of any new capital gains tax relief legislation.

H.R. 1033, introduced last week by Congresswoman Dunn and Congressmen Herger, Weller, Collins, Christensen, Ensign, and others, provides for such rollovers as part of a larger package of broad-based capital gains tax cuts. I believe that such a comprehensive approach is the most effective means to promote savings and investment.

Yet, I also believe the small business capital gains rollover proposal has great merit as a freestanding bill, the approach taken by Senator Daschle and other Senate Democrats in S. 20.

I also wish to note the important work Congressman Matsui had done in this area.

Finally, I very much recognize that if we are to balance the budget, as we must, any tax proposal, no matter how worthy, must promote maximum growth on a cost-effective basis. On that count, the rollover is a winner.

The Joint Tax Committee has estimated the rollover legislation introduced in the 104th Congress, which is very similar to H.R.

1033 and S. 20, which would cost a total of \$100 million over 7 years.

Mr. Chairman, I think you will agree that in the context of capital gains, that figure, \$100 million over 7 years, approaches de minimis.

Mr. Chairman and Congressman Rangel, I have prepared a more detailed statement, and Members of the Committee, I have prepared a more detailed statement which I ask for your permission to be included in the record. I would be happy to answer any questions you or the Committee may have, and I can't thank you enough for inviting me to have this opportunity to present this legislation as I see it.

Thank you very much.

[The prepared statement follows:]

**Statement of J. Morton Davis, Chairman of the Board, D.H. Blair
Investment Banking Corp., New York, New York**

SUMMARY

Mr. Chairman, Congressman Rangel, and members of the Committee, I very much appreciate the opportunity to present testimony to the Committee on the pressing question of how we may most effectively promote the capital formation needed to fuel economic growth and job creation in our country. I thank the Committee for seeking to address this problem.

The Congressional debate over capital gains taxes is no longer focused on the question of whether there should be a capital gains tax cut. Both the President and a great majority of members of Congress have called for some type of capital gains tax relief to be enacted. As a result, the question now before Congress is how to structure a capital gains tax cut so as to create the most new jobs, provide for the largest increase in capital spending, and generally best stimulate economic growth—while minimizing the loss of tax revenues to the federal treasury.

I am testifying today in support of legislation which I strongly believe would best meet those criteria: targeted capital gains tax relief to small companies. Specifically, this legislation would build the pool of investment capital available to small businesses by deferring taxes on capital gains realized from direct investments in small companies so long as those gains are reinvested in similar companies. These tax-deferred roll overs would work much like the tax treatment afforded to those who sell a home and purchase another within two years, or those who roll over their IRAs or 401(k) plans from one investment to another.

Mr. Chairman, you rightly have called for reform of the tax code to promote investment and eliminate the bias towards consumption. The “roll over” proposal would do both. Other witnesses today favor lowering capital gains rates overall, a goal I very much support. The “roll over” legislation would lower capital gains rates on an entire class of investments to the lowest rate of all—zero. By eliminating the tax on capital gains, the market would be allowed to allocate capital to where it would do the most good. On the other hand, if gains were not reinvested, but instead were used for consumption, that consumption would be taxed immediately.

Congressman Rangel, the “roll over” proposal also would help achieve your goal of ensuring that the economic growth and job creation which we all want includes those persons who historically have not shared fully in the American Dream. “Roll over” legislation now before Congress would ensure that sufficient investment capital is directed to small businesses, which have proven to be the most potent catalysts for economic development and job growth in distressed urban areas.

Capital spending by small businesses produces jobs, and lots of them. As an investor, I repeatedly have observed that if an investment is made in a large company, that money often is parked in an account for an indefinite period before it is put to productive use. But when a small company receives a check, it goes out—not in a year, not in a month, but the very next day—and hires workers and purchases equipment. Yet larger companies have much easier access to capital—through banks, commercial paper, and established public markets for their debt and equity. The “roll over” proposal would provide small, entrepreneurial businesses with the capital they need.

I strongly believe that the small business capital gains “roll over” proposal is a critical component of any capital gains tax relief legislation. H.R. 1033, “The Return

Capital to the American People Act” introduced by Congresswoman Dunn and Congressmen Herger, Weller, Collins, Christensen, Ensign, and others, provides for such “roll overs” as part of a larger package of broad-based capital gains tax cuts. I believe that such a comprehensive approach is the most effective means to promote savings and investment. Yet I also believe the small business capital gains “roll over” proposal has great merit as a freestanding bill, the approach taken by Senator Daschle and other Senate Democrats in S. 20, “The Targeted Investment Incentive and Economic Growth Act of 1997.”

Finally, I very much recognize that if we are to balance the budget, as we must, any tax proposal, no matter how worthy, must promote maximum growth on a cost-effective basis. On that count, the “roll over” is a winner. The Joint Committee on Taxation has estimated that H.R. 1785, roll over legislation introduced in the 104th Congress which is very similar to H.R. 1033 and S. 20, would cost a total of \$100 million over seven years. Mr. Chairman, I think you will agree that, in the context of capital gains, that figure—which does not give any effect to taxes paid by new businesses as they become profitable, or the taxes paid by the people employed by such businesses—approaches de minimis.

In sum, I very much support prompt enactment of small business capital gains “roll over” legislation such as that included in H.R. 1033 or S. 20. The remainder of my testimony seeks to address policy considerations and technical issues relating to such legislation.

Small Business is Key to Job Creation, Economic Growth, and Technological Innovation

In all probability we are not going to beat the newly industrialized countries of Asia and other regions in relatively mature industries, but we can surely improve our competitive position and leave them decades behind in what our pioneering and entrepreneurial spirit enables us to do best—the development of new technologies and new products in such emerging fields as biotechnology, telecommunications, space and aerospace, superconductivity, laser technology, medical and pharmaceutical products, and all of the exciting yet undreamed of products of the 21st century and beyond.

If we look historically at our economy, it is small, entrepreneurial businesses which have created the most new jobs, invested the greatest percentage of their assets in new equipment, and provided the greatest percentage of technological breakthroughs and new products for each dollar invested. The entrepreneurial effort, resourcefulness, and creativity which characterize American small businesses have, over the years, spurred the growth of our economy. Today, small businesses are leading the way down the information superhighway, and they are in the forefront of biotech research that will improve the quality of life for us, our children, and our children’s children by providing cures to devastating diseases, alleviating our most painful and life-destroying maladies, and halting or even reversing the aging process.

Starting and promoting small businesses is an integral part of the American Dream. One need only think of how Edison’s inventions and Henry Ford’s first assembly line changed the world forever, or, more recently, of how Ray Kroc went from selling multimixers from the back of his station wagon to build McDonalds, or how Bill Gates’ first software program mushroomed into Microsoft, and you begin to get an idea of the billions of dollars of goods and services and the millions and millions of jobs that exist today thanks to past investment in developing companies. We as a people are amazingly good at developing new technologies and new products—better than anyone else in the world—and this is where we can shine competitively and truly excel. And this is precisely the area where the roll over is focused by providing incentives to invest in new and small businesses.

Every day, workers are being laid off by large corporations. In most cases, those jobs are gone forever. It’s only the new smaller companies that can create the needed new jobs. Already, more than a third of America’s workers are employed by businesses with fewer than 100 employees, and that percentage continues to rise, and more than 80% of all businesses in America have fewer than 50 employees.

Simply put, new and smaller firms create the overwhelming majority of new jobs and economic growth. Thus, any legislation which seeks to promote economic growth must foster the growth of small companies.

Numerous studies have concluded that small and newly created firms play an important role not only in job creation but in the process of technological innovation and new product development, processes critical to future U.S. competitiveness.

A U.S. Commerce Department study pointed out that from 1982 to 1989 large United States multi-national corporations generated a domestic employment gain of less than 1%, while the nation’s total non-agricultural payrolls rose approximately

21%. Our large corporations, which in 1982 represented approximately 21% of the nation's employment, accounted for less than one tenth of 1% of the job growth from 1982–1989. These corporations' share of total employment fell from 21% to 17% during the same period. Additionally, these major corporations contributed less than 15% of the country's total gross national product growth from 1982 to 1989.

A 1989 study completed by the National Association of Securities Dealers, Inc. and the Economic Research Bureau of the State University of New York at Stony Brook, "The Economic Impact of IPOs on U.S. Industrial Competitiveness," provided startling data as to job and technology advances provided by companies publicly raising money for the first time. The study covered 426 initial public offerings in 1983, 1984, and 1985 and tracked the performance of these companies through 1987. These offerings related to companies which are typically start up or small companies.

In short, the NASD/SUNY-Stony Brook study demonstrated that: (a) industry employment by all public companies dropped at an average annual rate of 6.5% while the IPO firms increased their employment at a rate of 29.8%; (b) IPO firms grew more than three and half times faster than industry in general, increasing their sales at an average annual rate of 34.6% compared with 9.4% for industry as a whole; (c) while IPO firms could be expected to increase their invested capital faster than industry in general, the margin of difference was more significant than would have been expected—IPO firms grew at an average annual rate of 51.8%, or more than seven times faster than the industry average of 7.2%; and (d) IPO firms increased their capital spending more than 10 times faster than industry in general, or 62.7% versus 6.0%.

A third study, "Tax Incentives For Investing in Emerging Firms; A Strategy for Enhancing U.S. Competitiveness," by Robert J. Shapiro of the Progressive Policy Institute concluded that "emerging firms create most of the new jobs in the U.S., generate more technological advances than other companies and generally provide more of the innovations that are critical to U.S. competitiveness." The study further stated that "by definition, a new company creates employment; in fact the data [discussed in this study] show that new and young companies are primary forces in new job creation." Mr. Shapiro in his study also concluded that small corporations outpaced established companies in their rates of expenditures, especially for research and development and commercialization of new products and services.

Yet another study, by the Massachusetts Institute of Technology, reported that from 1982 to 1986 the total number of Americans working increased by 9.3 million. Firms which were organized during this period, however, created nearly 14.2 million jobs, and another 4.5 million new jobs were created by companies with less than 100 employees. Thus the new jobs created during this period by these newly organized businesses exceeded the entire job growth during this period. The Fortune 500 companies actually decreased their total employment by approximately 20% in the 1980s and early 1990s.

In a June 1996 article in *Worth* magazine, Peter Lynch observed, "Younger, more aggressive companies are challenging the older companies or starting new industries from scratch. The jobs lost when the older companies falter are made up and then some in the younger companies that succeed." In support of that conclusion, Mr. Lynch presented data which indicated that 25 of the nation's largest companies shed a total of 360,000 jobs between 1985 and 1995, while 25 new companies, many of which barely existed a decade ago, added over one million jobs over the same period.

My own experience, gained over 30 years of raising equity capital for hundreds of new and emerging small companies, overwhelmingly supports this statistical evidence.

Even larger U.S. corporations acknowledge the crucial role of smaller companies in forging important technological advances. This is evident in the increasing number of instances in which large U.S. corporations enter into joint research and development efforts with small entrepreneurial companies or acquire or make substantial equity investments in these companies to gain access to their technology base. These actions reflect a recognition that these smaller companies—with their more dynamic, pioneering, entrepreneurial, non-bureaucratic structure—are responsible for much of the nation's growth and are better able to find creative solutions to problems, which is necessary in the creation of new technology and new products.

TAX RELIEF FOR CAPITAL GAINS REINVESTED IN SMALL BUSINESSES WOULD CREATE JOBS AND BUILD THE POOL OF CAPITAL AVAILABLE FOR PRODUCTIVE INVESTMENT

In assessing the various capital gains tax cut proposals now before Congress, lawmakers should seek to determine the best means to achieve three goals:

- Create new jobs

- Stimulate capital investment
- Promote the development of new products and technologies which will produce an ever-improving quality of life for our citizenry and enable United States' businesses to compete effectively in world markets

Targeted capital gains tax relief for small businesses in the form of tax-deferred "roll overs," such as those included in H.R. 1033 and S. 20, would contribute mightily to achieving each of these objectives.

Deferring taxes on capital gains which are reinvested is a proven means of promoting savings and investment. Several tax code provisions already provide for tax-deferred roll overs, most notably that afforded homeowners who sell their primary residence and purchase another within two years. The concept would apply just as well to the reinvestment of capital gains realized upon the sale of small business stock.

Both Republicans and Democrats have recognized the merits of a small business capital gains "roll over" provision. Generally, Democrats favor enacting the proposal in lieu of broad-based capital gains cuts. Senate Minority Leader Daschle has taken such an approach in S. 20. Republicans, on the other hand, generally support the targeted small business capital gains "roll over" proposal as part of a larger package of broad-based capital gains tax relief. I believe either approach would greatly benefit the economy.

Targeted capital gains tax relief for small businesses effectively complements broad-based capital gains tax cuts, and should be a part of any capital gains tax relief package which is enacted by the 105th Congress. I wish to underscore that passage of broad-based capital gains relief in no way eliminates the need for a "roll over" provision. The two proposals are not redundant. They differ in four principal ways:

- First, a "roll over" provision would defer the entire capital gains tax on covered transactions. Thus, 100 cents of every dollar of gain would be available for reinvestment. The most common broad-based capital gains tax cut proposals would provide for an effective rate of between 14% and 19.8%, thus leaving only 80–86 cents for reinvestment after the tax is assessed.

- Second, the tax deferral afforded by "roll over" legislation would be available only if the gain was reinvested, while the broad-based cuts would apply even to gains which were built up in prior years and are cashed in for purposes of consumption. Thus, the "roll over" legislation is a more effective means of addressing the tax code's general bias against savings and investment in favor of consumption.

- Third, a "roll over" specifically would promote capital formation for small, entrepreneurial ventures, which create the most jobs and have the most pressing capital requirements.

- Fourth, "roll over" legislation is vastly less expensive than broad-based capital gains. As discussed below, the Joint Committee on Taxation has estimated that "roll over" legislation introduced in the 104th Congress which is very similar to H.R. 1033 and S. 20 would cost a total of \$100 million over seven years. The broad based capital gains cuts included in the Balanced Budget Act of 1995 would cost \$35 billion over the same period.

In short, the targeted "roll over" provisions of H.R. 1033 and S. 20 should be a key component of any legislative effort to spur economic growth. It doesn't reward money stuffed in a mattress or blue chip stock certificates locked in bank vaults. It doesn't reward the substitution of equity for debt incurred for the leveraged buy outs of large corporations, a class of transactions which do little to encourage new investment in equipment, research, and job formation. What it does reward is risk taking—taking risks in the emerging growth businesses which create new jobs and new technologies—the same risk taking that made America great, and the same risk taking that can make America great again.

THE JOINT TAX COMMITTEE HAS STATED THAT SMALL BUSINESS CAPITAL GAINS "ROLL OVER" LEGISLATION WOULD HAVE A VERY MODEST IMPACT ON TAX REVENUES

The Joint Committee on Taxation has concluded that providing targeted capital gains tax relief to small businesses by deferring taxes on capital gains realized from direct investments in small companies so long as those gains are reinvested in similar companies would have a very modest impact on federal tax revenues relative to other capital gains tax proposals.

Specifically, the Joint Committee estimated that H.R. 1785, a bill introduced in the 104th Congress which is very similar to the "roll over" provisions of H.R. 1033 and S. 20, would result in a tax revenue loss to the federal treasury of a total of \$100 million over seven years. Significantly, the revenue estimate for H.R. 1785 even included losses attributable to a provision which would eliminate, only for in-

vestments in small businesses, the current law cap on the amount of capital losses which could be offset against ordinary income. The latter provision would particularly benefit middle income investors who do not have extensive portfolios which they can manipulate to produce capital gains to match against capital losses.

Relative to other capital gains tax proposals, the cost of the targeted roll over proposal is de minimis. For example, the Joint Committee scored the capital gains tax reforms passed by the 104th Congress as part of the Balanced Budget Act of 1995 as costing over \$35 billion over seven years.

CAPITAL GAINS LEGISLATION SHOULD BE DRAFTED TO FACILITATE, NOT IMPEDE,
PRODUCTIVE INVESTMENT

If capital gains tax relief is to be effective, it must facilitate, not impede, productive investment. Specifically, the market, not the artificial constraints of the Internal Revenue Code, must be permitted to allocate capital to where it will do the most good. Because holding period requirements impede the flow of capital, they must be imposed only where they serve legitimate policy ends.

Based on my decades of experience as an investor, I believe there are two legitimate reasons for imposing holding periods. First, preferred investors who are granted special access to initial offerings of securities should not be afforded any tax benefits for selling those interests for an immediate windfall. Quite often, a security sold in an initial public offering spikes up in value over the original offering price within hours of hitting the market. No public policy interest is served by encouraging sales at that point; such "flipping" does nothing to promote productive investment. However, those "spikes" tend to last as little as a few hours, and in my experience, almost never more than a few weeks, after which the stock value tends to plateau. Thus, I believe a holding period of as little as three months would address the "flipping" issue effectively.

The second legitimate reason for imposing a holding period requirement is to impede disinvestment, that is, the cashing in of capital gains which are not reinvested productively, but instead used for purposes of consumption. To achieve that goal, holding periods of nearly any length may be justified, although a simpler, and more effective approach would be to impose a significant tax on consumption, that is, capital gains which are not reinvested, and impose little tax or, better still, defer the entire tax on those gains which are reinvested.

The "roll over" provisions of H.R. 1033 and S. 20 provide that stock in a small company must be held for a minimum of six months in order for gains realized upon the sale of such stock to be eligible for tax deferrals upon reinvestment. I believe such a holding period is sound: it prevents "flipping" but does not impede legitimate reinvestment. Moreover, it has strong historic precedent: from 1942 through 1988, except for a single eight year period, the Internal Revenue Code required stock to be held for six months to be eligible for tax treatment as long-term capital gains. (More recently, the Code requires a one year holding period for long term capital gains.) The robust economic growth of the first several decades of the post-war era, growth which was characterized by the creation of vast numbers of new businesses and GDP increases far exceeding those of recent years, conclusively rebuts the notion that a six-month holding period renders entrepreneurs excessively vulnerable to the vicissitudes of capital markets.

Section 1202 of the Code, the small business capital gains provision enacted in 1993, provides for a five-year holding period. Five years is simply too long: I have observed that investors have almost ignored section 1202 because they are unwilling to tie up capital long enough to qualify for the tax benefits it confers.

Significantly, Congressman Matsui, the lead House sponsor of the legislation which ultimately became section 1202, has introduced legislation which would both reduce the five year holding period requirement for gains which would qualify for a reduced tax rate and provide for the deferral of capital gains which are realized on investments in small companies which are "rolled over" into similar investments. Yet Congressman Matsui's bill, H.R. 420, requires that small business stock be held for three years in order to qualify for both a reduced rate and tax-deferred roll over. As noted, it may be appropriate to impede disinvestment by imposing a lengthy holding period for those seeking to disinvest their gains and use those resources for consumption. However, the tax code should not present a barrier to reinvestment of capital gains. Thus, the three year holding period set forth in H.R. 420 may be appropriate for the rate reduction component, but the six month holding period set forth in H.R. 1033 and S. 20 constitutes more sound tax policy with respect to the roll over component.

We cannot afford to introduce impediments and disincentives to investments in small emerging businesses. As long as the investment serves to launch a new com-

pany or expand an existing business with the vitally important attendant creation of new jobs, we should not require capital to be "locked in" for years. Indeed, ample testimony before the Committee correctly notes that "capital lock" is among the biggest problems created by the high capital gains rates currently in force. A number of commentators have called for the tax code to encourage "patient capital." They are correct. Yet from the standpoint of the company in which the investment is made, equity capital is the most patient capital of all—it is permanent capital. And only gains on original issues of equity would be eligible for a tax-deferred "roll overs" under H.R. 1033 or S. 20.

An excessive holding period—in my view, anything beyond six months—would drastically limit the pool of potential investors to those who can afford to tie up their funds for a long time. An excessive holding period also would significantly lessen the incentive by removing the possibility of a relatively prompt gain, and as a result of such reduced incentive, necessarily would reduce the number of persons willing to risk investing in small entrepreneurial companies. I emphasize that it is the possibility of a quick gain that is important. In fact, the investment will almost always be held for more than six months. Yet holding out the possibility of an early gain, and having taxes on those gains deferred, is what will create the real incentive for investors to take the extra risk of funding new and small businesses.

What we need to do is to encourage investments in small businesses so as to achieve the positive results which derive from such investments. Locking in capital for a predetermined period is counter to the purpose of promoting investment in small companies. The sooner the money is reinvested, the sooner it can go to work again. This multiplier effect increases the pool of investment capital, and permits it to be reinvested where it does most good.

In sum, targeted capital gains tax relief for small businesses in the form of tax-deferred "roll overs," such as those included in H.R. 1033 and S. 20, are the single most effective legislative means to help new and small companies and to promote savings and investment in the economy as a whole. Such legislation deserves the support of this Committee, the Congress, the President, and all Americans, and should be a part of any capital gains tax relief package which is enacted by the 105th Congress.

Mr. Chairman, thank you again for the opportunity to testify today.

Chairman ARCHER. Mr. Davis, thank you for your testimony, and without objection, your entire written statement will be included in the record, as will be true for all of the witness.

Mr. Rangel, would you like to inquire?

Mr. RANGEL. Thank you.

Mr. Davis, did I understand you to say that the cost of this is *de minimis*?

Mr. DAVIS. Yes. The Tax Committee headed, I believe, by Mr. Kies, whom I saw here earlier, after some time developed the scoring on this, and on a static scoring, it was their advice to us and to the Congress that the cost would be \$100 million over 7 years on a static basis. That is not considering that many of these companies, these new and small businesses, entrepreneurs, will be hiring employees that will be paying, and certainly, within 7 years, in a dynamic situation, the companies themselves will be developing and growing and paying taxes. So it is \$100 million over 7 years, yes, very correctly.

Mr. RANGEL. Well, I have heard this type of optimistic report. Certainly, it sounds more favorable when you are dealing with small businesses because in America that is truly where the jobs are. I will be interested in having Mr. Kies share the result of the Joint Committee's work on this so that I will be able to share it with other Members. Maybe the Chairman might want to comment on that because it would seem like those very new figures are rath-

er low. Perhaps they are using his new method of scoring, which is creative, but not accepted at this time.

Let me thank all of you, but especially you, Mr. Davis.

Mr. DAVIS. I always appreciate your brilliance of wisdom, and the Chairman's as well. You are two of the greatest statesmen in the history of our country. Thank you again.

Chairman ARCHER. Mr. Davis, after what you have said about both of us, I think maybe you might be preparing to run for public office.

Mr. DAVIS. No, I just want to support great people like you. You guys do a great job.

Chairman ARCHER. Thank you very much.

Ms. Collins, do you wish to inquire?

Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. I appreciate the opportunity to ask a couple of quick questions here.

Mr. Davis, I appreciate the leadership you have had in small business issues and job creation as a professional and attracting investment.

I note with great interest and, of course, am proud to cosponsor legislation referred to in your testimony.

I noticed toward the end of your written testimony, you make a point regarding excessive holding periods.

Mr. DAVIS. The what?

Mr. WELLER. The excessive holding periods.

Mr. DAVIS. Yes.

Mr. WELLER. Requiring to hold assets for a long period of time.

I was wondering if you can explain to me, just so I can better understand, how you feel that by having longer holding periods, how that would discourage investment and the creation of small business and entrepreneur activity.

Mr. DAVIS. Well, something that is decidedly desirable, you don't want to introduce any disincentives to the success of such a program, and I think if you are familiar with the history, Bumpers-Matsui or Matsui-Bumpers introduced a bill several years ago that said if you held an investment for 5 years, I think you pay half the prevailing capital gains, and if you hold it 10 years, I think you pay no capital gains tax.

That bill was such a disincentive that I think, even though it is in effect several years, nobody has even asked for the regulations.

If it is useful, first of all, equity capital, as distinguished from debt capital or any other capital, equity capital is permanent capital. You can't take it back. If I give a company some money to put into the business, they have it forever. I can seek to fund another buyer, but from the company's point of view, it is permanent capital. So this idea of having somebody hold it 2 years, 3 years, 4 years, or 5 years serves little or no purpose. I don't see any purpose, and we do insist—we have introduced as we have refined this—to avoid people that maybe get into issue and kick it out 2 hours later, the free riders or flippers, as they call them on Wall Street. We have introduced something in discussing with Treasury. We have to hold it at least 6 months or you avoid that kind of thing, but to the extent that somebody is successful and selling it to somebody else, from the company's point of view, it is permanent

capital, and then he can turn around and use that money and has to use that money within 6 months, reinvest it in another new company, otherwise he is taxed.

It is an incentive to build a large formation of capital for that segment of the economy that hasn't got the availability, as big companies do, and it is important for women, it is important for minorities. It is important for all of us because that is this segment of this country that has produced the largest growth over the last decade and beyond. I hope that answers your question.

Mr. WELLER. Yes, it surely does. Essentially, you are saying that the opportunity for fairly quick gain actually attracts more investment than new activity.

Mr. DAVIS. Congressman, we have an evergrowing pool, as a guy has made a profit, and he has to reinvest the corpus, plus the profit, again, in a new or entrepreneurial or a small business, the ones that are creating all the jobs.

As I pointed out, the Fortune 500 have been downsizing, and I am sure you are well aware of that. All the new jobs have come from these small companies, and all the women are going to new businesses at an accelerated rate. We have to make capital available to that group, and that is where all the great new ideas come from.

We often fund guys right out of MIT and Harvard and Stanford, and if they didn't have access to this kind of capital, they would never get funded.

I am sure you know friends that try to start businesses. They run around addressing their friends, scrambling around, and it is very, very hard to get that kind of capital.

So we have to say, in response for your taking the bigger risk, that if you have a gain, you can reinvest that gain, and other companies of the same nature. That helps the growth of our country.

Mr. WELLER. Thank you. Thank you, Mr. Davis.

Mr. DAVIS. Thank you very much.

Mr. WELLER. Thank you, Mr. Chairman. That concludes my questions.

Chairman ARCHER. Gentlemen, thank you very much. The Committee will benefit from your testimony, each of you.

The Committee has no further business today. The Committee will stand adjourned.

[Whereupon, at 4:05 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of John W. Cox, BMC Software, Inc.; on Behalf of American Alliance for Software Exports

I am John W. Cox, Tax Director for BMC Software, Inc. headquartered in Houston, Texas. BMC is a member of the American Alliance for Software Exports (AASE), on whose behalf this statement is submitted in support of H.R. 143, The Software Export Equity Act, and the Administration's FY 1998 Budget proposal to clarify the application of Foreign Sales Corporation (FSC) incentives to exports of software licenses.

The AASE applauds the leadership of Representatives Dunn and Matsui in introducing H.R. 143, which clarifies that the export of software that is accompanied by the right to reproduce qualifies for FSC incentives. We are pleased that similar legislation (S. 387) has been introduced in the Senate by Senators Hatch, Nickles, Baucus and Breaux. The fact that three-quarters of the members of the Ways and Means Committee have co-sponsored this legislation clearly demonstrates that this legislation has broad, bipartisan support. We commend the Ways and Means Committee for their support of this legislation.

The AASE also applauds the Administration for recognizing the importance of providing FSC incentives to software exports by including, and funding, a proposal to resolve this issue in their Fiscal 1998 Budget. The Administration's proposal, however, is effective only for software licenses granted after the date of enactment. Because many software licenses with third-party distributors are multi-year agreements, relating the effective date to licenses granted after a certain date will force software companies to renegotiate these licenses. We would appreciate the opportunity to work with the Committee on drafting a more appropriate effective date.

I would like to be clear. The U.S. software industry is not seeking any new benefit or special treatment. As I will outline in this statement, all the industry is seeking is equal treatment under existing law. We believe Congress always intended for software to be included as part of the FSC statute. We find no evidence Congress ever intended to exclude software. To the contrary, we find strong evidence that Congress intended to include such industries as software.

The AASE is a group of high technology companies and state, local and national trade associations representing every region of the country. AASE members include the Alaska Division of Trade & Development; Alaska Hi-Tech Business Council; American Electronics Association; Arizona Software Association; Association of Information Technology Professionals; Austin Software Council; Business Software Alliance; Capitol Region Software Alliance, New York; Chicago Software Association; Colorado Software Association; Computer Software Industry Association, California; Computing Technology Industry Association; Connecticut Technology Council; Council for Entrepreneurial Development, North Carolina; Eastern Technology Council, Pennsylvania; Electronic Industries Association; Greater Baltimore Committee Technology Council; Independent Computer Consultants Association; Independent Computer Services Association of America; Indiana Software Association; Information Industry Association; Information Technology Association of America; Information Technology Business Center, Pennsylvania; Information Technology Training Association; Interactive Digital Software Association; Interactive Multimedia Association; International Compact Disc Interactive Systems; Maine Software Developers Association; Massachusetts Software Council; Michigan Technology Council; Minnesota Software Association; NASDAQ Stock Market; National Multimedia Association of America; National Venture Capital Association; New Hampshire High Technology Council; New Orleans Technology Council; Niagara Software Executives, New York; North Carolina Electronic & Information Technology Association; Northeast Software Association, Connecticut; Northern Virginia Technology Council; NPES, the Association for Suppliers of Printing and Publishing Technologies; Pittsburgh High Technology Council; Research Triangle Software Developers Roundtable, North Carolina; Rhode Island Economic Development Corporation; Rhode Island Software Association; San Diego Software Industry Council; Silicon Prairie Technology Association, Missouri; Silicon Valley Software Industry Coalition, California; Software Association of Oregon; Software Council of Southern California; Software Executives Group of Central & Western New York, Software Forum, California; Software Industry Coalition, California; Software Publishers Association; Software Valley Corporation, West Virginia; Southeastern Software Association; Suburban Maryland High Technology Council; Technology Council of Central Pennsylvania; United States Council for International Business; Utah Information Technology As-

sociation; Virginia Department of Business Assistance; Washington Software & Digital Media Alliance; Western Massachusetts Software Association.

BMC is a worldwide developer and vendor of software solutions for automating application and data management across host-based and open system environments. As is typical of members of AASE, exports comprise a substantial portion of BMC's sales; more than 40 percent of BMC's over \$500 million in revenues is from exports.

High technology industries are important to the future economic strength of the United States. In the 1980's, the high technology industry focused on advancements in hardware. In the past few years, however, attention has turned to software. Software includes both the system software and applications software that enable computers and other electronic products to perform faster and more varied functions. Today, the United States is a world leader in software development and employs approximately 600,000 people in the United States in high-skilled software development and servicing jobs, including BMC's nearly 1,000 employees in Texas. The Commerce Department estimates that every \$1 billion of export trade is worth 19,000 domestic jobs.

INTRODUCTION

The tax code, through the FSC rules, currently provides a tax incentive to U.S. exporters of goods developed in the United States. AASE members are unified in their objective to clarify that the FSC rules apply to all software exports.

Due to a narrow IRS interpretation of the FSC rules, the export of software products that is accompanied by a right to reproduce the software is barred from receiving this export incentive. This interpretation unfairly discriminates against exports of software since virtually all other U.S. produced exports, from airplanes to toothpaste, are eligible for FSC incentives. The IRS interpretation is particularly unfair because master recordings of motion pictures or music for reproduction outside the United States, which are distributed with reproduction licenses in the same manner software is distributed, are eligible for FSC incentives. The FSC rules provide an important incentive for U.S. companies to produce their products in the United States for sales overseas. Given many of the high-skilled jobs associated with software development, it should be equally, if not more, important to provide FSC incentives to software as it is to provide these incentives to airplanes, toothpaste, motion pictures, musical recordings or any other U.S. produced exports.

In addition, the FSC rules are extremely important to smaller businesses because the FSC incentives help reduce the costs of entering the export market. In fact, the FSC statute includes specific rules which make it easy for small companies to qualify for FSC incentives. Since software companies have the opportunity to enter the export market at a very early stage in their life cycle, it would be especially helpful if they could utilize the FSC rules, as all other industries can.

CONTRIBUTIONS OF THE U.S. SOFTWARE INDUSTRY TO THE U.S. ECONOMY

The U.S. software industry makes significant contributions to the U.S. economy.

1. The U.S. software industry employs thousands of high-skilled programmers to develop the software that is its product. Software companies create thousands of new jobs each year. These high-skilled jobs are the type of jobs that Congress and the Administration have emphasized they want to encourage through their economic policies.

2. The U.S. software industry invests heavily in research and development to create new products for world markets. This helps both to create new technologies and advance existing technologies, resulting in the United States being a world leader in the development of new technologies.

3. The U.S. software industry produces products that are in high demand both in the United States and abroad. The demand for U.S.-developed software outside the United States has led to a surge in the exports of U.S. software. These exports reduce the trade deficit of the United States and help expand the markets for American-made goods, resulting in more U.S. research and development and high-skilled jobs for software programmers and others in the United States.

The U.S. software industry is currently a world leader. However, like other U.S. exporters, FSC incentives will serve to further enhance the industry's competitiveness. The FSC incentives will particularly assist small and medium-sized software companies in entering the world market, by enabling them to reduce the cost of exporting. Moreover, all software companies must weigh the net cost of exporting from the U.S. against the cost of developing foreign products in foreign jurisdictions. It is important to note that many foreign governments have realized the many economic benefits associated with the fast growing software industry. These foreign

governments are actively working to attract software companies to their countries by offering substantial tax and other financial incentives.

HOW THE U.S. SOFTWARE INDUSTRY CONDUCTS BUSINESS

Software programmers conduct research and development activities in the United States for the development of software products. These software programmers are highly-skilled employees who add significant value to the software product. U.S. software companies license their software to customers in both the United States and abroad.

A U.S. software company that markets its software to foreign customers usually licenses a master copy of the software to foreign customers, including third-party distributors, original equipment manufacturers (OEMs) and value-added resellers (VARs). Distributors and VARs may translate the software into the language of the local country and reproduce it for license to customers in that country. In addition, software is routinely licensed through OEMs who install the software on their hardware and sell the bundled package of software and hardware. In other cases, software may be licensed to VARs, who add their own software to the licensed software and then reproduce the combined software for sale. These are all important distribution networks for exports of software and greatly enhance the industry's ability to export its products efficiently and effectively. Because software programs are constantly being updated and improved, large physical inventories of software are impractical and very expensive to maintain. The licensing of an updated master copy through OEMs, VARs, and third-party distributors is the most efficient and cost-effective method for the U.S. software industry to export its products.

Software publishers are increasingly entering into "site licenses" with some of their larger customers. A site license is the licensing of a master copy of the software directly to the customer. A site license enables the customer to make as many individual copies of the master copy as required to meet its needs. Also, in some instances, large foreign customers prefer to do business with local companies (i.e., foreign subsidiaries of U.S.-owned companies). In these instances, the U.S. company will transfer the master copy to its foreign subsidiary that will, in turn, enter into a site license with the foreign customer.

Legislative History of the Application of the FSC Rules to Software and Later IRS Interpretations

In 1971, Congress enacted the Domestic International Sales Corporation (DISC) legislation to encourage the export of U.S. produced goods in order to help U.S. companies compete in overseas markets and so improve the nation's balance of payments. Additionally, by encouraging the export of U.S. produced goods, Congress hoped to keep manufacturing jobs in the United States as well as create new jobs. In 1984, the DISC provisions were replaced by the FSC rules. The FSC rules had the same purpose as the DISC rules, but eliminated some of the provisions in the DISC rules that our trading partners found objectionable under GATT.

Under the FSC provisions, the export of certain intangibles is ineligible for FSC incentives. Section 927(a)(2)(B). Specifically excluded are "patents, inventions, models, designs, formulas, or processes, whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property." This language is identical to the language contained in the DISC statute written in 1971 (see section 993(c)(2)(13)). Neither the statute nor the legislative history contains any language that specifically precludes software from qualifying for DISC or FSC incentives. The legislative history to the FSC provisions provides no explanation of this section of the bill. The legislative history to the DISC provides the following explanation of this section of the bill.

Although generally, the sale or license of a copyright does not produce qualified export receipts (since a copyright is generally not export property), the sale or lease of a copyrighted book, record, or other article does generally produce qualified export receipts. House Report No. 92-533, 92nd Cong., 1st Sess. 69 (1971), 1972-1 C.B. 498, 535; Senate Report No. 92-437, 92nd Cong., 1st Sess. 102 (1971), 1972-1 C.B. 559, 616.

Treasury regulations interpreting the DISC statute rely on this legislative history in providing that a copyrighted article (such as a book), if not accompanied by a right to reproduce it, is export property. The regulations also state that a license of a master recording tape for reproduction outside the United States is qualified export property.

Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes,

records, or similar reproductions, for commercial or home use), goodwill, trademark, trade brand, franchise, or other like property. Although a copyright such as a copyright on a book does not constitute export property, a copyrighted article (such as a book) if not accompanied by a right to reproduce it is export property if the requirements of this section are otherwise satisfied. However, a license of a master recording tape for reproduction outside the United States is not disqualified under this subparagraph from being export property. Reg. § 1.993-3(f)(3).

The eligibility of software for DISC incentives was first addressed in 1985 when the IRS National Office was requested to provide technical advice on whether so-called “box top” or “shrink-wrap” software sold or leased outside the United States on a mass market basis qualified for DISC benefits. In Technical Advice Memorandum 8549003, the IRS stated:

The “films, tapes records, or similar reproductions” language of section 993(c)(2)(B) is not limited as to subject matter. Since copyrighted computer software is marketed on magnetic tapes for commercial use, such tapes seem to specifically qualify based on the Code language. However, it is unclear whether Congress intended this provision to apply to other than entertainment industry tapes. Based upon the earlier drafts of section 993(c)(2)(B), it could be argued that Congress intended qualification for only tapes that are like films or records, i.e., videotapes or musical tapes. See H.R. 18392, 91st Cong., 2d Sess. (1970) and H.R. 18970, 91st Cong. 2d Sess. (1970), in which the proposed version of the parenthetical exception of finally enacted section 993(c)(2)(B) only applied to films and tapes produced by the entertainment industry. However, one could also argue that since the finally enacted provision does not seem to be solely limited to the entertainment industry, such provision should not be interpreted in a restrictive manner. [Emphasis added]

Without concluding whether software on magnetic tape was meant to be within the parenthetical exception to section 993(c)(2)(B), the IRS concluded that the software at issue was eligible for DISC incentives because the provisions seemed to include as export property finished products or inventory items.

In a later technical advice memorandum, the IRS more decisively reached the conclusion that the parenthetical exception in section 993(c)(2)(B) did not seem to be limited to the entertainment industry, and, therefore, the provision should not be interpreted in a restrictive manner. However, in ruling that the software, tapes in this case, which were produced in the United States and sold or licensed outside the United States on a mass market basis, were qualified property, the IRS relied on the regulations under the DISC rules, which permitted copyrighted books to qualify for DISC. (TAM 8652001).

Although it seems clear that software tapes qualify as “tapes” under sections 993(c)(2)(B) and 927(a)(2)(B), the phrase “similar reproductions” clearly is broad enough to include the licensing of software. This is because the production of a master software tape, and the medium and the manner in which it is reproduced and distributed, are very similar to the manner in which the entertainment industry produces and distributes its products. For example, it is common for both films and software master tapes to be exported to distributors who will translate the tape into the local language and reproduce it for distribution in that country. Additionally, today more and more music and software are reproduced on compact disks, using almost identical equipment and production processes. Furthermore, the direction the technology is taking is that distribution of films, tapes, records, videos, software and any other type of digital information will be done electronically rather than by shipping physical copies. Finally, the explosion of entertainment software, which include films and music recordings, provides strong evidence for consistent treatment. Thus, we believe the language chosen by Congress for the parenthetical exception was intended to be broad enough to encompass exports, like software, that are exported in the same manner as films and records.

Despite these IRS opinions and the broad language of the statute, the temporary FSC regulations issued in 1987, interpreting language identical to that interpreted by these opinions, adopted a narrow interpretation of the parenthetical exception that the IRS interprets as denying any FSC benefits for the license of software if the license is accompanied by the right to reproduce the software. (TAM 9344002).

The FSC regulations substantially parallel the DISC regulations. However, regulation writers in 1987, now cognizant of the existence of the U.S. software industry, decided to specifically address software in regulations promulgated under FSC. The regulation writers made a determination to treat mass marketed software as a copyrighted article that is eligible for FSC benefits. They also made a decision not to treat a license of a software program for reproduction outside the United States like a master recording tape, which is also eligible for FSC incentives. In these regulations, the IRS effectively narrowed the scope of property eligible for FSC incentives to exclude a major portion of software exports—licenses of software with the right

to reproduce. Temporary Regulation § 1.927(a)-1T(f)(3), which defines intangible property that is excluded from the definition of FSC export property, states:

Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, trade brand, franchise, or other like property. Although a copyright such as a copyright on a book or computer software does not constitute export property, a copyrighted article (such as a book or standardized, mass marketed computer software) if not accompanied by a right to reproduce for external use is export property if the requirements of this section are otherwise satisfied. Computer software referred to in the preceding sentence may be on any medium, including, but not limited to, magnetic tape, punched cards, disks, semiconductor chips and circuit boards. A license of a master recording tape for reproduction outside the United States is not disqualified under this paragraph from being export property. Temp. Reg. § 1.927(a)-1T(f)(3). [Emphasis added]

IRS effectively narrowed the scope of property eligible for FSC incentives to exclude a license of software with the right to reproduce.

The narrowing of the definition of export property to exclude software licenses that permit reproduction of the software has no basis in the statute or legislative history to the DISC or FSC rules, but was based on an administrative decision by the FSC regulation writers at the IRS that software tapes were neither "tapes" nor "similar reproductions" within the meaning of the statute. Despite the fact that the legislative history provides no basis for limiting these terms within section 927(a)(2)(B)'s parenthetical to the entertainment industry, the IRS regulation writers made a decision to do so. Not only does this ignore the way that software is exported, it ignores the similarities between the film, record and software industries. The future direction, driven by technology, is that all digital information, whether it be music, video, or software, will be distributed in the same way. No logical distinction has ever been made between these different products.

AASE strongly believes that Congress' statute, specifically allowing for "similar reproductions" to qualify for DISC and FSC treatment, recognized the need for the legislation to address developing industries and new means of doing business like software. We do not believe that Congress in enacting the FSC rules intended to deny incentives to the software industry. Indeed, the Administration recognizes that software licenses should be provided FSC incentives, as they have included a legislative proposal to address this issue in their FY 1998 Budget. AASE strongly supports the Administration's legislative proposal to provide FSC incentives to software licenses.

SUMMARY

The software industry is an important contributor to the economy of the United States today and will continue to be in the future. The software industry creates many new high-skilled jobs in the United States, helps the United States to maintain its position as a world leader in the high technology field and is a large and growing source of U.S. exports, the revenue from which reduces the U.S. trade deficit. The failure to permit exports of software to qualify for FSC incentives is counterproductive to the continued growth of this industry. In addition, there is no tax policy reason for denying exports of software the same FSC incentives that are available to virtually all other U.S. exporters.

We are on the brink of an explosion in the global use of information technology. The United States is well-situated to turn that economic reality into immense growth and job opportunities for the United States. In times of tight budgets and tough choices, we are not looking for handouts or special treatment. We are looking for a clarification in existing law, so that the U.S. software industry can continue to do what it does best, create and market high-value, job creating products across the globe. AASE strongly supports the Administration's budget proposal to provide a legislative solution to this problem, and urges Congress to enact H.R. 143, the Software Export Equity Act, which would clarify that the definition of FSC export property includes the license of software to distributors and customers with the right to reproduce.

Statement of American Bankers Association

The American Bankers Association (ABA) is pleased to have an opportunity to submit this statement for the record on certain of the savings and investment provisions of the Administration's fiscal year 1998 budget proposal.

The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, savings banks and thrifts—makes ABA the largest banking trade association in the country.

The Administration's 1998 revenue plan contains several significant proposals of interest to banking institutions which, with modification, would provide much needed tax relief, as set out more fully below.

INDIVIDUAL RETIREMENT ACCOUNTS

The Administration's proposal to expand the availability of individual retirement accounts (IRAs) is of particular interest to ABA. The banking industry fully supports efforts to revitalize IRAs, and we are particularly pleased that the concept of tax-advantaged retirement savings has garnered long-standing bi-partisan support. In this regard, we note that ABA fully supports the expanded IRA proposed by Representatives William Thomas (R-CA) and Richard Neal (D-MA) in H.R. 446. That legislation would provide a model IRA vehicle designed to address the nation's need to increase retirement savings.

By way of background, the personal savings rate in this country has trended down over the past several decades. During the 1970s, individuals saved 7.8 percent of their disposable income; in the 1980s, the personal savings rate declined to 6.5 percent; for the first half of the 1990s, individuals saved only 4.7 percent of their disposable income. This declining trend means that individuals will be less prepared to meet the variety of financial needs they are likely to encounter during their lives—including buying a home, paying for college, covering medical emergencies and providing an adequate retirement income. Since savings and investment are critical ingredients in economic growth, a declining savings rate also has negative implications for the future of our economy and for our ability to create new jobs.

The primary appeal of the IRA concept to individuals is based upon the tax advantage associated therewith. That tax advantage is often viewed as a supplement to savings, making the IRA an appealing product for an individual's long-term savings growth. Individuals concerned about the availability of retirement funds can appropriately complement social security and other retirement savings vehicles with IRAs. Once an IRA has been established, the tax penalties that accompany early withdrawals provide further encouragement to save for the long-term.

The challenge, then, is to develop a viable IRA product with sufficient appeal to attract a wide range of individuals to participate. We believe that, to be successful, an IRA must meet three criteria:

- first, it must be simple enough to be easily understood by consumers;
- second, eligibility criteria must be sufficiently inclusive to permit broad participation; and
- third, it must be flexible enough to be responsive to the financial needs of today's consumers.

If such criteria are met, we believe that individuals will view the new and improved IRAs as valuable tools for long-term savings, and the product will be far more successful than the IRA vehicle that is currently available.

Simplicity

One problem that has diminished the effectiveness of the current version of the IRA for bank customers is its complexity. Particularly, the rules for determining eligibility for today's IRAs are simply too difficult to understand. Millions of consumers have been so confused about the tests, eligibility determinations, and income limitations, that even when they are eligible, many individuals do not participate in IRAs. The problem has been exacerbated by the changes, and by constant discussions of changes, in IRAs. We recommend that any new proposal be simple to understand in its terms and conditions.

Eligibility

In 1981, almost all working Americans were eligible for IRA coverage, and IRAs became immensely successful. However, after the 1986 tax reform act, the eligibility rules were changed dramatically—individuals covered by private pension plans were no longer eligible and the income limits established (\$25,000 for individuals and \$40,000 for couples) significantly reduced eligibility. Participation declined dramati-

cally and contributions have continued to shrink every year since 1986—40 percent of the eligible taxpayers are not currently using IRAs.

Inflation also contributed to the decline in the effectiveness of IRAs. Many of those in the low to middle income bracket who remained eligible after the 1986 tax act have gradually been forced out of eligibility simply because of inflation-based pay increases. In the near future, inflation will continue to shrink the base of those eligible to invest unless some type of indexing is permitted under the statute.

For a tax-favored savings incentive to be effective in generating new savings, the pool of those eligible to participate in the plan should be as wide as possible. The Administration's plan would, *inter alia*, raise and index the income limitations on deductible IRAs. The proposal represents an important first step in resolving the eligibility problem of the currently available IRA vehicle. It could be further improved by eliminating income phaseout limits altogether, which would allow a much greater number of individuals and households to participate in the expanded IRA vehicle.

Flexibility

If there is any single reason why people have been reluctant to establish IRAs, it is probably the lack of flexibility. Individuals are understandably concerned about sinking their money into a totally illiquid account from which funds can not be retrieved without significant penalties—except by crossing the retirement age threshold. For a savings incentive to work, people need to have a certain comfort level that their savings can be accessed for emergencies and for certain other important expenditures.

We also believe that a plan should be flexible in offering a range of options to the customer. The current savings proposals differentiate between whether the IRA is “front-loaded” or “back-loaded.” With a front-loaded IRA, the taxpayer may take a tax deduction for the amount of the contribution. Alternatively, with a back-loaded IRA, there is no tax deduction for the contribution; instead, all earnings and contributions from the investment can be withdrawn tax-free for qualifying expenditures, as well as at retirement age. A tax-favored savings plan should be flexible enough to offer both options to customers, since the decision as to which plan would be preferred may differ among individuals. An IRA plan should also protect the contribution limits from erosion by the effects of inflation so that contribution limits will not need to be adjusted by law in the near future.

Economic Benefits of an Expanded IRA

A properly designed retirement savings instrument will result in higher usage by individuals and more long-term savings. One of the most important long-term issues for this country is inadequate savings. Savings promote capital formation, which is essential for job creation, opportunity and economic growth.

The Administration's proposal represents an important first step in resolving the eligibility problem of the current IRA vehicle. It could be further improved by eliminating income phaseout limits altogether, which would allow a greater number of individuals and households to participate in the expanded IRA vehicle.

CAPITAL GAINS

We would like to commend Representatives Philip English (R-PA) and Robert Matsui (D-CA) for introduction of the “Enterprise Formation Act of 1997,” (H.R. 420). We would also like to commend Representative Jennifer Dunn (R-WA) for introducing H.R. 1033, the “Return Capital to the American People (ReCAP) Act.” The bills would provide much needed improvements to existing small business stock investment tax incentives. The ReCAP Act would also provide a broad-based capital gains tax cut and index the basis of capital assets for inflation.

ABA is pleased that the subject of capital gains rate reduction has garnered bipartisan support. We fully support the enactment of tax legislation that incorporates targeted investment incentives for small business along with a broad-based capital gains cut.

Broad-Based Capital Gains

The current tax regime essentially discourages investment in the most efficient, highest return opportunities. A broad-based capital gains rate cut would reduce the cost of capital and encourage the use of equity financing, rather than debt, for business activities. It would benefit a wide variety of income groups and economic sectors, including retirees, middle income families, large and small investors, businesses, farmers, and entrepreneurs. According to the 1996 Congressional Budget Office report, in 1989, thirty-one percent of families with incomes under \$20,000 owned capital assets, not including their personal residences. For families with in-

comes between \$20,000 and \$50,000, the figure was fifty-four percent. Also, according to the Investment Company Institute, approximately sixty-percent of households earning \$50,000 or less own mutual fund investments.

Capital gains tax relief is necessary in order to increase capital formation, stimulate saving and investment, raise domestic wages, and to boost domestic economic growth. Accordingly, a broad-based tax cut would impact virtually every sector of the American economy.

Venture Capital

Under the present law, venture capital investment of corporations is effectively taxed at three levels: (1) the earnings of the recipient of the capital are subject to the regular corporate income tax, (2) the gains earned by the venture capital subsidiary are subject to the corporate income tax, and (3) distributions to individual stockholders of the investing corporation or the bank holding company parent are once again taxed. Reducing the capital gains tax rate is expected to "unlock" capital assets, lower interest rates and spur the economy, resulting in raising federal revenues. It would also encourage venture capital investments by financial institutions by lowering the excessively high cost of capital.

The banking industry is actively involved in the venture capital business and is a vital source of venture capital funding. Banks represent a stable source of venture capital that has provided a cushion during periods when other sources of capital have contracted. By obtaining funds from the parent holding company, banks provide consistent, long-term support for the venture firms. Bank venture capital subsidiaries are also less subject to the fluctuations of the availability of venture capital funds and may also diversify their portfolios across industries and geographic regions to reduce risk.

Many of the larger U.S. commercial banks have non-bank venture capital subsidiaries which obtain funding from a parent bank holding company. In recent years, commercial banks have provided between 6 and 13 percent of all new venture capital invested each year and have more than \$5 billion invested in venture capital.

Generally, investment in the stock of young entrepreneurial firms is among the most productive of investments. According to the Small Business Administration, a new job is created for every \$17,000 of venture capital invested. These high risk, innovative and usually highly technical enterprises often must rely on investor purchase of stock to finance their operations. Most venture companies have little or no operating history and virtually no sales. A very large percentage of them produce losses or fail. However, successful venture businesses are among the fastest growing domestic companies. A reduction in the rate of capital gains tax on corporate venture capital investments is not only appropriate but sorely needed to stimulate continued job growth and development. We urge you to include a broad-based capital gains tax cut in the budget bill's tax package along with targeted venture capital investment incentives.

ESTATE TAX RELIEF FOR SMALL BUSINESS

Under the current law, a unified credit of \$192,800 is provided against the estate and gift tax, which effectively exempts the first \$600,000 in taxable transfers from tax. If the estate tax is imposed, it is due within nine months of a decedent's death. Internal Revenue Code section 6166 provides that an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate pays only interest for the first four years, followed by up to 10 annual installments of principal and interest. A special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1,000,000 in value of the closely-held business. A special estate tax lien applies to property on which the tax is deferred during the installment payment period. Interest paid on the deferred estate tax is allowed as a deduction against either the estate tax or the estate's income tax.

Financial institutions routinely serve as corporate fiduciaries for trust administration or as personal representatives for estate administration. According to the Federal Financial Institutions Examination Council's 1995 report, entitled, "Trust Assets of Financial Institutions," approximately 2,700 financial institutions are currently engaged in trust activities which include estate administration. Said institutions hold approximately \$21 billion in estate assets in either a discretionary or non-discretionary capacity, representing approximately 49 million estate administration accounts.

Banks, through their trust departments, provide a variety of personal fiduciary services, such as settling an estate following the death of a client. Settling an estate may involve a series of actions from the admission of a will to probate court to the

final distribution of assets to the estate beneficiaries. By way of example, in an estate settlement, the bank would serve as either executor or administrator of the estate. As personal representative, the bank's responsibilities would include providing legally required notice to heirs, beneficiaries, and interested persons; collecting and appraising assets; drawing up a budget for payment of estate obligations and, if necessary, selling assets to meet outstanding debts; safekeeping assets; making tax elections; settling all tax obligations (income taxes and state and federal estate taxes); assessing claims filed against the estate; making a final accounting to the probate court; and finally, distributing any remaining assets to the beneficiaries.

The Need for Estate Tax Relief

The present law often causes family businesses to be sold, at the worst possible time, in order to pay estate tax. More than 70% of family businesses and farms do not survive through the second generation, and 87% do not survive through the third generation. Indeed, the White House Conference on Small Business Commission called for repeal of the estate tax because it was considered one of the paramount threats to family-owned inherited businesses and a disincentive to growth.

We agree with the Conference's Report. We also believe that the Internal Revenue Code—particularly with respect to estate and gift taxation—has become overly complex. Taxpayers expend significant resources on compliance activities. Similarly, banking institutions expend significant resources on training trust department employees in estate planning and administration. Thus, estate tax simplification would benefit customers as well as banking institutions. Of course, any change should not sacrifice simplicity in exchange for vitally needed estate tax relief.

We note that the estate tax has also had an inordinate impact on farmers. In this connection, we would respectfully call to your attention the February 25, 1997 testimony of Keith Collins, Chief Economist, Department of Agriculture before the House Committee on Agriculture. In that testimony Mr. Collins pointed out that over 75 percent of a farm's assets (such as real estate) can not be easily liquidated to pay the estate tax without disruption of the farm as a going business. A quick or "distress" sale to raise cash would probably result in sale of the farm at a lower than market rate, with harmful results to the taxpayer and any lenders involved.

Recommended Solutions

The ABA supports the legislative proposals to increase the unified credit amount. This much needed modification would both simplify the Code and reduce the estate tax for small business owners and farmers. The credit amount, set in 1981, is not indexed for inflation and has not been increased. Indexed for inflation, the \$600,000 value exemption would be \$830,000 in 1997 dollars. Today, taxpayers may easily exceed \$600,000 in value by simply owning a home, a modest investment portfolio, life insurance (the face amount of the policy is subject to estate tax), and retirement benefits. A family business will greatly increase the odds of exceeding the tax-free limit.

Further, the relief provided by Code section 6166 may, as a practical matter, be unavailable to many taxpayers. By subjecting the business property to a tax lien, credit availability may be limited and the day-to-day operations may be impeded. Further difficulties may arise if the value of the property or business declines during the installment period. In the event of a bankruptcy, the estate tax would remain due, with the bank-fiduciary required to continue payment irrespective of the absence of cash from the estate. Moreover, the fees due to the bank for such services would not be paid. Also, the installment method involves complex rules and prevents a quick and simple closing of the estate.

The Administration's proposal would make several modifications to Code section 6166: increasing the amount of value for eligible business from \$1,000,000 to \$2,500,000; providing that interest paid on the deferred estate tax would not be deductible; reducing the 4 percent rate to 2 percent; and subjecting the deferred estate tax on any value of a closely held business in excess of \$2,500,000 to interest at a special rate. It would also authorize the Secretary of the Treasury to accept security arrangements in lieu of the special estate lien. The Administration's proposal would do much to remedy the problems faced by small businesses owners and farmers; but it would not simplify the estate tax laws. It would still necessitate extensive estate planning and add complexity to the administration of estates.

We note that Senate Finance Committee Chairman William Roth (R-DE) has introduced the "American Family Tax Relief Act," S.2, which would increase the unified estate and gift tax credit over an eight-year period beginning in 1997 from an effective exemption of \$600,000 to an effective exemption of \$1,000,000. The bill would provide special estate tax treatment for "qualified family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. It

would exclude the first \$1,500,000 in value of qualified family-owned business interest from the decedent's estate and would also exclude 50 percent of the remaining value of qualified family-owned business interests. The bill would also extend the Code section 6166 installment period from 14 years to a maximum of 24 years, with the estate paying only interest for the first four years, followed by up to 20 installments of principal and interest. There would be no interest on the amount of deferred estate tax attributable to the first \$1,000,000 in value of the closely held business.

Although we believe that the estate tax relief provisions of S. 2 may be a step in the right direction, we are concerned that compliance with the qualified family-owned business rules would require adherence to an overly complex set of rules, which, due to their long-term application, may prove to be more problematic than the current installment rules. Additionally, the American Family Tax Relief Act is unclear with respect to the treatment of qualified family-owned businesses held within trusts.

Accordingly, we would urge you to include provisions pertaining to "death tax" relief in the form of raising the unified credit amount in the fiscal year 1998 budget.

CONCLUSION

We appreciate having this opportunity to present our views on these issues. We look forward to working with you in the further development of solutions to our above-mentioned concerns.

Statement of David Rhodes, President, School of Visual Arts, New York, New York; Chair, Federal Advocacy Committee, Association of Proprietary Colleges

I am David Rhodes, President of the School of Visual Arts in New York City and Chairman of the Association of Proprietary Colleges' (APC) Committee on Federal Advocacy. On behalf of APC, I want to thank Chairman Archer and Members of the House Committee on Ways and Means for holding these hearings and permitting our Association to submit testimony regarding the Savings and Investment Provisions in the Administration's Fiscal Year 1998 Budget Proposal.

We commend both the Administration and numerous Members of Congress for recognizing that the education of our population should be a federal priority and for proposing many new and creative ideas to assist parents and students with obtaining the education, training and retraining they will need to lead productive lives and become active knowledgeable citizens in our rapidly-changing world.

The Association of Proprietary Colleges is a group of 31 degree-granting colleges located in the State of New York. Most of our members' colleges offer associate degree programs. My own institution, the School of Visual Arts, confers baccalaureate degrees and master of fine arts degrees. Many of our members' colleges are small family-owned businesses, some of which have been in existence for more than 100 years. Even our youngest member was established more than 20 years ago. The average placement rate for our students exceeds 90 percent. Our graduation rates exceed those of other educational sectors in the State.

In order to remain competitive, we must and do maintain a close working relationship with the marketplace, expose our students to the latest technology, and equip our graduates with the advanced conceptual skills required for entry into the business world. Because we receive no public subsidies to attract, retain and graduate students in a world which changes as rapidly as ours does, we have developed structures and mechanisms which allow for unusual flexibility in tailoring curricular and support services to better educate our students for a society whose pace of change is increasing. We are mindful that our times call for multiple careers, for we know that the average student today can anticipate eight different jobs in a lifetime.

New York State recognizes and separately regulates two kinds of postsecondary institutions: non-degree granting trade, technical or business schools and degree granting institutions of higher education. For the State of New York, the type and level of the program offered by an institution are paramount. Corporate structure is not a factor in the State regulatory apparatus. Proprietary colleges are institutions of higher education whose programs are evaluated using the same regulations and staff as all other institutions of higher education. Trade schools, whether for-profit, not-for-profit, or public are governed by a separate set of regulations that are administered by a different staff. Only institutions of higher education, for example,

may grant credit-hours while postsecondary trade, technical and business schools must use a contact-hour format to measure the length of their programs.

Although New York State has been regulating education for more than 200 years, and has therefore been able to take the time to refine its practices with unusual precision, the difference between postsecondary nondegree training and higher education at the associate, baccalaureate or postbaccalaureate level is clear throughout the country. Since the regulation of education is a state and local matter, it seems to us that those states which have permitted qualified proprietary institutions to become institutions of higher education should not have their considered judgments preempted at the federal level.

Unfortunately, the Department of Education categorizes institutions by their corporate structure and not by the quality or level of education their students receive. Within the Higher Education Act, there are basically two definitions of "institutions of higher education." Section 1201(a) of the Higher Education Act of 1965 defines only public and nonprofit institutions as those "institutions of higher education" eligible for institutional aid. Approximately 2,500 institutions nationwide are included in this definition.

Section 481 of the same Act defines "institutions of higher education" that are eligible participants in student financial aid programs. This is a much broader definition and includes diverse institutions providing a wide range of programs: public, nonprofit, for-profit, short-term programs, foreign medical schools, foreign graduate medical schools, etc. We estimate that approximately 6,000 institutions are included under this definition.

CONCERNS

Our primary concern is that our students receive the same benefits from the federal government as students who attend private and nonprofit institutions. Since proprietary colleges meet the same state standards as public and nonprofit institutions, we believe our students should receive equal treatment.

Many of the new proposals, particularly those favoring expanded uses of Individual Retirement Accounts (IRAs) to encourage parents to save for college, cite Section 135(c)(3) of the Internal Revenue Code of 1986 in defining "institution of higher education." This definition, in turn, refers to Section 1201(a) of the Higher Education Act of 1965, as amended through 1988. Students attending our two-year, and (as in my own case) four-year degree-granting proprietary institutions would not be permitted to pay tuition from money their parents were encouraged to set aside in an IRA.

In addition, the 1201(a) definition will present some enormous administrative burdens. Program quality and reputation are the significant determining factors in choosing an institution of higher education for most families, not corporate structure. The only way to ensure compliance with the section 1201(a) definition would be through an Internal Revenue Service audit years after the funds have been spent. We find it difficult to believe that you would sanction such intrusions by the Federal Government into these most intimate family decisions.

SOLUTIONS

We urge the Committee on Ways and Means to revise the tax code to make higher education more affordable for parents and students. Students attending those proprietary institutions which have been authorized by their appropriate state regulating agency to confer degrees should have the same right as students attending other public and nonprofit institutions. The Committee should define "institution of higher education" as it is defined under Section 481 of the Higher Education Act of 1965.

Although we have not seen the final Hope Scholarship proposal submitted by the Administration, we support the concept behind this initiative to extend study for two additional years beyond high school. However, if the proposed Hope Scholarship is offset dollar-for-dollar by a student's Pell Grant, state financial aid, and/or with private scholarship aid, we fail to see how access to higher education is enhanced by this proposal. This is particularly true in states, such as New York, that maintain extensive financial aid programs. Therefore, we would urge the members of the Ways and Means Committee to permit needy students to receive the full benefits of Pell Grants, state financial assistance, and private scholarships in addition to the Hope Scholarship.

I appreciate the opportunity to submit written testimony on behalf of the Association of Proprietary Colleges. If I or the Association can provide additional information, please contact us.

Statement of the Independent Bankers Association of America

Mr. Chairman, Members of the Committee: The Independent Bankers Association of America (IBAA) appreciates the opportunity to submit its views on the Clinton Administration's tax proposals to the House Ways & Means Committee, which under the Constitution is the starting point for tax legislation.

IBAA represents more than 5,500 locally-owned community banks nationwide, and is the only trade association that exclusively represents the interests of such independent banks. Our median bank holds about \$50 million in assets, has about 25 employees and two branches. The core business of these banks is financing small businesses, farms, ranches, and local consumers.

Our Association wishes to commend this Committee, for getting under way a hearing that will explore the vital areas of savings, investment, and family business continuity, and the Administration for submitting proposals in each of these areas. These initiatives, by President Clinton and Members of Congress offer possible avenues to common ground, which could promote enactment of critical and long-delayed tax relief that would benefit the U.S. economy as a whole over the long term.

PROPOSALS FOR INCREASING RETIREMENT SAVINGS ARE ALIGNED

IBAA agrees with the Treasury Department's warning, earlier this month that the U. S. personal savings rate—critical for the retirement security of an aging American population is disturbingly low, having declined from 7.7 percent over the 1960–86 period to 4.9 percent in 1996 (Statement of Deputy Secretary of the Treasury Lawrence Summers before the Senate Finance Committee, March 6, page 2).

We also recall the conclusion of Federal Reserve Chairman Alan Greenspan before this Committee in 1991, that increasing individual savings and national investment are the highest economic priorities. IBAA so testified before this committee on January 31, 1995, in favor of enhancing tax-favored savings products. Since then, bipartisan efforts have succeeded in enacting the Spousal IRA provision in 1996. However, Secretary Summers confirmed that the U.S. savings rate remains significantly below the average of industrialized countries with which the U.S. competes.

In this context, we feel the renewal of the President's four-part proposal to double the income eligibility for deductible contributions, create a "back-loaded, nondeductible IRA as an alternative, index eligibility and contribution levels and broaden withdrawal privileges under certain circumstances, is very constructive. Broadening IRA's has a respectable lineage for both Democrats and Republicans—before it was a Lott-Roth bill, it was Roth-Breaux bill, and, before that, a Bentsen-Roth bill.

We believe opening the most attractive type of Individual Retirement Account investment to a larger population would be a powerful incentive to both prospective savers and the institutions holding, administering (and marketing) these funds.

For example, financial statistics reflect that three-fourths of all U.S. banks hold IRA or other retirement accounts. So, the banking system, among other service providers, is ready, willing and able to expand retirement account services to the public. Banks believe they have something special to offer, in that bank-IRAs are insured against loss up to \$100,000.

Before IRAs were cut back in 1986, they were attracting approximately \$38 billion of retirement savings. In the past few years, the annual total has hovered around \$10 billion. So, there appears to be a potential for sizable increases in IRA savings. It is encouraging that President Clinton's proposals and the Congressional proposals of Representatives Thomas and Neal (H.R. 446) in the House and of Senators Lott-Roth-Breaux (Title IV of S. 2 and S. 197) in the Senate are similar in outlook and direction. Great benefits to the economy would result if these proposals were blended and enacted.

CAPITAL GAINS PROPOSAL ADVANCES THE DISCUSSION

In the capital gain area, the Clinton Administration, which advanced a proposal favoring small business and venture capital in 1993 (that became law), has taken another worthwhile initiative with its proposal to exempt \$500,000 of value in the sale of a residence.

We believe the homeowner exemption is based upon at least three principles: (1) the value of a residence accumulates over a long period, (2) it is often a family's primary asset, and (3) it seems unfair to most Americans to tax a family on a nest-egg of a reasonable amount.

What seems most promising to us is that these principles also apply to family farms and small businesses. One problem in cross-applying this limitation directly

was discussed at the Senate Agriculture hearings of February 26, by IBAA witness John Dean. Most farmers live modestly, and would not be able to take full advantage of a residence exemption at that level. However, if such a concept can be applied generally to the build-up of farm and small business assets, there appears to be a significant opportunity to make progress in the closely related areas of capital gains and estate taxes, the interaction of which does much to determine whether farms and small businesses to pass from one generation to another.

ESTATE TAX PROBLEM IS RAISED

In the estate tax area, the Administration's deferral-of-payment proposal recognizes that there is a problem, but not what the problem really is. A fraction of U.S. businesses (30 percent) are passed down to a second generation and only 13 percent make it to a third generation, according to the SBA, despite the American Dream of family business succession. Federal estate taxes, that rise steeply to 55 percent and were last adjusted by 1981 legislation, are a prime cause of this attrition.

This impact of estate tax is basically unfair to family and small commercial and agricultural enterprises. Importantly, the income tax exemption is adjusted for inflation, but the estate tax exemption is not. Also, as federal estate taxes are structured, the most enterprising elements of our population are frequently taking a triple-hit. First, all business income is taxed as it is earned. Second, business assets are subject to tax again at death, at a very high rate. Third, many farm and business estate must sell part of the enterprise to pay these taxes, often at distressed prices because they are "forced sales." Other heirs must mortgage their farms or businesses to the hilt for 20 or more years to literally buy them back from the federal government.

The maximum estate tax rate was scheduled to fall from 55 percent to 50 percent after 1993, but the reduction was postponed to raise more revenue. Some argue that estate tax reductions should not take place until the budget is balanced. Our customers can't wait indefinitely; half of U.S. farmers are age 57 or older.

COMMON BUDGET CONTEXT

At the beginning of this year, there seemed to be an agreement in concept between the Executive and Legislative Branches that the budget should be balanced within the next five years in a way that would accommodate tax reductions decided to be most in the public interest.

Effective reform of estate tax, as well as savings and investment enhancements, would strengthen the common foundation of the American economy. These are the kind of tax reductions that should be compatible with efforts to balance the budget, because all are long-term projects. Estate tax relief, especially, can be phased in over a considerable length of time, as was done between 1981 and 1986.

Moreover, there appears to be a realistic possibility that these tax measures will encourage increased investment, that will, in turn, boost federal and state tax revenues. If improvements in these three areas are reported from the Ways and Means Committee, there will be an opportunity, under the new rules, to obtain a dynamic revenue estimate to provide a concrete test of this proposition.

ESTATE TAX STRUCTURE IS A PARTICULAR PROBLEM

However, to freeze the estate tax structure for the indeterminate future would compound the problems for farm and business owners, and be, literally, counter-productive not only for these entrepreneurs, but for their communities across the country, and for our national economy.

The problems created by federal and state death taxes are a very serious and legitimate set of problems for the American small business community that need to be addressed. Our bankers have a world of first-hand experience with the adverse impact of federal estate on small and family firms. This experience impels us to strongly favor structural reform of federal estate taxes "to make possible orderly succession of ownership in key community-based businesses (including) financial institutions (and) agriculture" (IBAA Resolution, 1996).

We also support further reduction of capital gain taxes, but in ways that promote long-term investment in community businesses. To fulfil these objectives, we believe that capital gain tax reductions should be done in tandem with estate tax reduction and achievement of a balanced budget over the near term.

IBAA believes these two areas of taxation on tightly linked. The relative levels of capital gains and estate taxes powerfully influence the decisions of small businesses and farmers about whether to sell out or to keep their enterprises in the family.

The current maximum federal rates are 28 percent for capital gains and 55 percent for estate taxes. So, there can be as much as a 2:1 financial advantage in selling a business property. If the maximum capital gains tax is reduced, say to 20 percent, the differential might, in some cases, approach almost 3:1 unless some comparable adjustments are made in federal estate taxes.

THE ROLE OF FAMILY FARMS AND BUSINESSES

For more than 200 years in this country, entrepreneurs have been able to start farms and businesses and pass them along from one generation to another. These enterprises put down roots in their communities. Their owners come to know and care about their employees, their customers, their schools, churches and hospitals. They and family members volunteer at local charities and are a significant part of the cement of American life. Family stewardship of the land and other productive assets has worked well in this country.

Because of the fixed threshold of federal estate taxes, and the steeply graduated rates above that threshold, there is a real threat that federal estate taxes will destroy the system of existing family farms, businesses, and banks by taxing it out of existence. Giving substance to this threat is the fact that, since federal estate taxes were last adjusted legislatively in 1981, revenues from this tax have increased 150 percent, from \$6.389 billion in 1980 to an estimated \$15.924 billion in 1996.

This increase vastly out paced inflation, and is an indication that estate taxes are a growing source of revenues for the range of federal expenditures.

LIMITED VALUE OF A DEFERRAL PROVISION

When a farm or small business owner dies, typically federal estate taxes are due, within 9 months. IBAA believes that the estate tax installment payment privilege, under section 6166, is of very limited value, because the Internal Revenue Service acquires a "special lien" on the farm or business until the tax is fully paid. Conventional lenders are wary of extending credit to a business where the federal government is a senior creditor.

For this reason, section 6166 is little used now, and extending it to somewhat larger estates, as the Treasury Department recommends, would be almost entirely symbolic.

THE FUTURE OF MANY COMMUNITIES IN PERIL

No wonder that, in most cases, farm acreage or business assets must be sold off to pay the taxes, or the heirs must take out a mortgage, payable over 20 or more years.

The U.S. Department of Agriculture has estimated that 500,000 farmers over the age of 57 will retire in the next 10–20 years. That total could represent as much as one-quarter of U.S. family farms. How many of these farms and small businesses are going to make it over the next estate tax hurdle?

Two types of commercial businesses predominate in this country—local, family businesses and chain stores (e.g. Wal-Mart, K-Mart, Sears). The former pay estate taxes; the latter do not. So, across the economy, taxes discourage family ownership, pushing enterprises toward larger units that often are transferred to absentee owners who have few ties to the communities in which they operate.

Full interstate banking takes effect in the U.S. on June 1, 1997. Banks across the country must develop strategic plans that include whether they wish to continue as independents or whether they will seek to sell their franchise to another financial institution. Federal and state death taxes occupy a very significant role in this decision.

Today, community banks with less than \$100 million in assets—typical IBAA banks—make more small business loans than any other size category of bank. Studies show that these financial institutions (which hold about 10 of U.S. deposits) make almost 30 percent of small business loans of less than \$100,000. Often, a community bank is the only financial institution in a small town or rural area.

Banks as small as 8 employees and \$15 million in assets have experienced estate tax problems. Should current IBAA owners plan to increase their investment, to better serve their customers, and incur greater estate tax risks, or should they plan to sell out? If owners are replaced with less experienced branch managers, business and farm loan applications may be sent to distant cities for evaluation by specialists who are probably not well acquainted with either the owners or their communities.

ESTATE TAX STRUCTURE SHOULD BE MODIFIED

IBAA urges, in the strongest terms, that the current grim reaping machine of the federal estate tax be thoroughly reexamined, for both economic and social reasons.

These taxes discourage investment where we need investment to remain world-competitive. They separate our most enterprising people from the enterprises their families have built, where our nation needs to preserve traditional family enterprise.

An extensive study by the Heritage Foundation in Washington, D.C. concluded as follows: "the economic cost of the estate tax is many times greater than the revenue it produces, and its reach into American households extends far beyond those few who pay it . . . The hardest hit by the tax are small businesspeople who work hard to pass on an enterprise of value to their children. And its bias against saving and wealth generation is the antithesis of the American Dream." (August 21, 1996, pages 3, 29).

Fortunately, estate tax problems are increasingly being recognized. For example, in Iowa, Governor Branstad, on February 17, signed into law a bill that abolishes the state inheritance tax for lineal descendants. The combined vote of the Iowa House and Senate was 137-9.

SENATE MAJORITY AND MINORITY BILLS EXCELLENT DEPARTURE POINTS

Now that there is recognition, there should be action. On the federal level, IBAA supports the increase in the filing threshold from current \$600,000 as a desirable first step. But, this will not help many family businesses and farms. We believe it is important to note that, in IBAA's view, increasing the Unified Credit alone is not a cost-effective way of assuring the transfer of farms and businesses from one generation to another. It is more expensive because it applies to all assets, rather than just productive assets. Because of this, it is difficult, especially in the present budget climate to increase the Unified Credit enough to help production farms and modest sized community businesses.

To get the job done, recognition needs to be given to the family and small business character of these assets, and the fact that they build up over a lifetime of effort, and the continuous risk of the market. The Senate Leadership bills, authored by Majority Leader Lott and Finance Committee Chairman Roth (S. 2), and by Minority Leader Daschle (S. 20), are excellent points of departure for crafting appropriate legislation.

ADMINISTRATION PROPOSAL OFFERS COMMON GROUND

As noted above, President Clinton proposal a homeowners' exemption for the first \$500,000 of value in a residence may provide an avenue toward common ground. Since the same principles apply to a farm and a small business. We therefore hope, as Senator Lott has indicated, that there can be a convergence of interest that can lead to bipartisan legislation that will really work to permit the transfer of family assets, while guarding against abuse.

IMPORTANCE OF ENACTING LEGISLATION THAT IS EFFECTIVE

It is thus vital that the 105th Congress get estate tax reform right, because if the 1997-98 legislation falls short, there will be many more horror stories from farm and small business families before Congress comes around to this issue again. And, in the meantime, the character of American life may be changed permanently for the worse.

We hope that a bridge can be built between the President's proposals and the House and Senate Leadership proposals, so that legislation bringing about both a balanced budget and needed tax reductions, can be enacted sooner rather than later.

Thank you again for this opportunity to express our views. IBAA would be pleased to work with this Committee and the Congress to improve these areas of the tax laws, so they can truly promote the economic well-being of small independent enterprises, their communities and the national economy.

Statement of the Investment Company Institute

A. INTRODUCTION

The Investment Company Institute ("Institute"),¹ the national association of the American investment company industry, appreciates this opportunity to present its views on the Administration's proposal to expand IRAs. We commend the Committee for holding hearings on a topic so vital to our economy and the retirement security of millions of Americans.

The U.S. mutual fund industry serves the needs of American households saving for their retirement and other long-term financial goals. By permitting millions of individuals to pool their savings in a diversified fund that is professionally managed, mutual funds provide an important financial management role for middle-income families. An estimated 37 million households, representing 37 percent of all U.S. households, owned mutual funds in 1996.² Mutual funds serve as the investment medium for retirement programs, including IRAs and employer defined contribution plans (the largest type being 401(k) plans). As of December 31, 1995, mutual funds held over \$1 trillion in retirement plan assets, about 19 percent of the retirement market's total assets of \$5.21 trillion. The remaining 81 percent is managed by such institutions as corporations, pension firms, insurance companies, banks and brokerage firms. Of the retirement plan assets held by mutual funds, about half are IRA investments.³

The Institute has a long history of supporting legislative efforts to enhance individual retirement saving. For instance, we supported the establishment of the universal deductible IRA, as well as legislation creating the SEP, SARSEP and SIMPLE IRAs. We strongly opposed the 1986 Tax Act's restrictions on IRA eligibility. Moreover, we continue to support efforts, such as the AdAs and legislation introduced by Congressmen Thomas and Neal, H.R. 446, that would substantially expand IRA eligibility and simplify the tax rules associated with IRAs. Such legislation is both necessary and appropriate, because—

- First, Americans are not preparing adequately for retirement and need more opportunities to do so;
- Second, simple, universally-available IRAs will work to increase retirement saving; and
- Third, such IRAs will generate new additional saving that would not be made absent such legislation.

B. AMERICA IS NOT PREPARING ADEQUATELY FOR RETIREMENT

Stanford University Professor Douglas Bernheim found that members of the Baby Boom generation are saving at only about one-third the rate they need to maintain their pre-retirement living standards in retirement.⁴ Along that same vein, an Institute study of the "baby boom" generation similarly found that more than 6 out of every 10 "boomers" state that they are not saving for retirement even though more than half expressed concern about the inability to meet their financial needs after retirement.⁵

USA Today, on March 26, 1997, reported that 78% of retirees wish they had financially planned better for retirement; 42% of retirees wished they have saved more in retirement plans, while 37% wished they had opened IRAs or contributed to employer salary reduction plans.

C. A SIMPLE, UNIVERSAL IRA EFFECTIVELY INCREASES PERSONAL RETIREMENT SAVING

Our long time national experience with the IRA teaches that saving incentives work best if the rules are simple and consistent. In order for the IRA to be useful

¹The Institute's membership includes 6,266 open-end investment companies ("mutual funds") with assets of about \$3.627 trillion, approximately 95% of total industry assets, and over 59 million individual shareholders.

²See Brian Reid, "Mutual Fund Developments in 1996," Perspective, Vol. 3, No. 1 (Investment Company Institute March 1997).

³1996 Mutual Fund Fact Book, Investment Company Institute.

⁴Bernheim, B. Douglas, "The Merrill Lynch Baby Boom Retirement Index" (July 14, 1994).

⁵"The Baby Boom Generation, A Financial Portrait," Investment Company Institute (Spring 1991).

to Americans, it must be universally accessible, easy for the average American to understand, and easy to administer.

When Congress introduced universal deductions for IRAs in 1982, Americans took advantage of the opportunity. IRA contributions rose from less than \$4 billion in 1980 to approximately \$38 billion in both 1985 and 1986. At the IRA's peak in 1986, about 29% of all families with a head of household under age 65 had IRA accounts. Contrary to what IRA critics said at the time, these IRA contributions were not mainly "wealthy" families using IRAs as "tax shelters." In 1986, 75% of all IRA contributions were from families with annual incomes less than \$50,000.⁶ Moreover, the median income of those making IRA contributions (expressed in 1984 dollars) dropped by 24 percent, i.e., from over \$41,000 in 1982 to below \$29,000 in 1986.⁷ The program was, indeed, effective and was being used by middle-class Americans and encouraging them to save for retirement.

When Congress restricted the deductibility of IRA contributions in the Tax Reform Act of 1986, the level of IRA contributions fell sharply and has never recovered. In 1986, IRA contributions totaled \$38 billion; they were \$15 billion in 1987, but only \$8.4 billion by 1995.⁸ While it is true that as a result of the 1986 restrictions, many families are no longer able to deduct their IRA contributions, they still may take advantage of the tax deferral for earnings on non-deductible IRA contributions. This incentive, however, has proved extremely complicated and insufficient to induce continued participation in the IRA program. The 1986 changes introduced a level of complexity in an otherwise simple program that proved overwhelmingly oppressive to its success as a savings incentive program. Even among families not affected by the 1986 Act and who retained eligibility for fully deductible IRA contributions, IRA participation declined on average by 40% between 1986 and 1987, despite the fact that the change in law did not affect them.⁹

The lessons of the past are clear. First, deductibility matters to people. Although non-deductible IRAs are available to all working Americans, without the deductibility feature, there are insufficient incentives to save. A front-end tax incentive gives households an immediate incentive to save. It is our view that this immediate incentive is a powerful alternative to the usual preference for current consumption of income.¹⁰

Second, confusing rules undermine even the powerful incentive of deductibility. When the tax rules are not simple, individuals are confused as to their eligibility. The post-1986 IRA with multiple limits, set offs, exceptions, exclusions and other technicalities cannot be understood by most Americans. American Century Investments recently surveyed 534 "savers" with respect to the rules governing eligibility, contribution levels and tax deductibility have left a majority of retirement investors confused.¹¹ It is no wonder: today, IRS Publication 590, which deals solely with taxpayer use of IRAs, contains 70 (seventy) pages of explanations, examples, and worksheets on the subject. Simply put, individuals stop investing and financial institutions cease marketing activity when the product cannot be readily understood and easily explained.¹²

Experience clearly demonstrates that Americans respond enthusiastically to appropriately designed tax incentives aimed at increasing retirement savings. For example, last year Congress enacted legislation creating the SIMPLE, a simplified retirement plan for small businesses that (because of the administrative burden) could not offer a pension program for their workers. The Institute's members report immediate, strong employer interest in the SIMPLE. One member in particular reports that it has sold over 1,000 SIMPLE-IRA plans to small employers since the pro-

⁶Venti, Steven F., "Promoting Savings for Retirement Security," Testimony prepared for the Senate Finance Subcommittee on Deficits, Debt Management and Long-Term Growth (December 7, 1994).

⁷Hubbard, R. Glenn and Incentives: A Review of the Evidence" (January 19, 1995).

⁸Internal Revenue Service, Statistics of Income.

⁹Venti, supra at note 7.

¹⁰Hubbard and Skinner, supra at note 8.

¹¹American Century Investments asked survey participants, who were self-described "savers," ten general questions regarding IRAs. One-half of them did not understand the current income limitation rules or the interplay of other retirement vehicles with IRA eligibility. "American Century Discovers IRA Confusion," Investor Business Daily (March 17, 1997). Similarly, even expansive changes in IRA eligibility rules, when approached in piecemeal fashion, require a threshold public education effort and often generate confusion. See, e.g., Crenshaw, Albert B., "A Taxing Set of New Rules Covers IRA Contributions," The Washington Post (March 16, 1997) (describing 1996 legislation enabling non-working spouses to contribute \$2,000 to an IRA beginning in tax year 1997).

¹²For this reason, the Institute opposes the addition of any offset of IRA contributions against those of a 401(k) plan. Such a rule would add unnecessary complication to the IRA, confuse the public, place additional burdens on 401(k) plan sponsors, and create disincentives to save.

gram's inception on January 1, 1997. The reasons for such a high response rate are clear. First, the SIMPLE offers significant tax incentives. Second, the program's rules are indeed "simple," easy to understand and easy to communicate. Prior to 1986, the universal IRA had similar success and for precisely these same reasons.

D. IRAS CREATE NEW RETIREMENT SAVING

A great deal of research has been done on the effectiveness of IRAs as incentives for increased personal saving. Many studies have focused on whether the IRA tax incentive produces new saving or merely reshuffles existing saving from taxable to tax-favored accounts. Put differently, the issue is whether IRAs serve merely as a windfall to higher income taxpayers.

In study after study of this issue, economists have concluded that a substantial portion of IRA contributions in fact constitute new saving that otherwise would not have occurred. For example, extensive analyses of IRA contributors essors Steven Venti of Dartmouth and David Wise of Harvard. They estimate that 66% of the increase in IRA contributions come from current consumption, 31% from the tax subsidy and only 3% from reshuffled assets (emphasis added).¹³ Similar conclusions—that a substantial majority of IRA contributions represent new savings—has been reached in separate papers by Professor Hubbard of Columbia, Professor Skinner of the University of Virginia and Professor Thaler of University of Chicago.¹⁴ The IRA has resulted in additional saving in both tax-favored IRA accounts and non-tax-favored accounts. This is the kind of long-term saving that is essential to capital formation and economic growth.

E. CONCLUSION

Today's targeted individual retirement vehicles help millions of Americans secure their future retirement through long-term investment. By simplifying the IRA eligibility rules, making deductible IRAs available to as many Americans as possible and expanding IRA options, Congress can empower millions more Americans to save for their own long-term financial security.

Our recommendation: make the IRA available as broadly as possible; keep it simple; make it permanent.

THEDFORD, NEBRASKA

The Honorable Mr. A.L. Singleton
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Dear Sirs,

My name is Craig Miles, son of Sam and Charlotte Miles, of Thedford Nebraska. We own and operate a beef cattle ranch in the Sandhills of north central Nebraska.

Unlike some other ranchers in other regions or states that have extra resources, such as oil or mining for a diversified income, Sandhills ranchers survivability normally rest upon the beef industry. With this in mind, you can understand how important the beef industry is to us and our livelihood.

Although Estate taxes may be a key issue for some folks, it is not one for us, as my folks have unselfishly thought about the continuation of the business on down to the next generation and have taken the necessary steps to see that this is fulfilled. So at this time, I would like to explain to you why Capital Gains Tax is such a critical issue for us.

My father is physically ready to retire but feels like he can't afford to do so. He's 66 years old and has worked hard to all these years building the ranch's land base and cow herd. Operating expenses as well as property and other taxes have contin-

¹³Venti, Steven F. and Wise, David A. "The Evidence on IRAs," 38 Tax Notes 411 (January 1988).

¹⁴Skinner, Jonathan, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992); Hubbard, R. Glenn and Skinner, Jonathan, "The Effectiveness of Savings Incentives: A Review of the Evidence" (January 19, 1995); and Thaler, Richard H., "Self-Control, Psychology, and Savings Policy," "Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth" (December 7, 1994).

ued to rise dramatically while cattle prices are at an all time low in years. Thus, my father had to put most of his equity back into the ranch. In recent years he has tried to put something away for his retirement but it was too late to have enough liquid assets for this. What he would like to do is liquidate part of the cow herd in order to fund his retirement, but after paying the capital gains tax there wouldn't be enough in reserve for this. In short he wants out but can't get there. What I would like to see is a break in capital gains for retirement age agricultural people if not the elimination of it.

Sincerely,

CRAIG MILES

Statement by National Apartment Association and National Multi Housing Council

We greatly appreciate the opportunity to speak in strong support of efforts by the committee to encourage savings and investment in America through changes in our Federal Tax Code and proposals to enact a broad-based reduction in capital gains taxes.

A reduction in capital gains taxes beyond those proposed for the sale of a personal residence, should be enacted only if the reduction is truly broad-based. Of particular concern is discussion in certain quarters that real estate should only receive the new lower capital gains tax rate on gain above original purchase price. Such a change in tax law would go against current tax policy that correctly recognizes real estate as a long-term wasting asset that should not be subject to depreciation recapture rules. As we will explain below, there are no sound tax policy reasons for changing the real estate depreciation recapture rules. Additionally, removing the benefit of lower capital gains taxes from commercial and residential real estate will result in fewer new jobs created and could seriously impact real estate investment and values; not unlike what happened to real estate in the post-1986 period.

The National Multi Housing Council (NMHC) and the National Apartment Association (NAA) represent the majority of the nation's firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the development and operation of apartments, including ownership, construction, finance, and management. The National Multi Housing Council represents the apartment industry's largest and most prominent firms. NMHC members are the principal officers of these organizations. The National Apartment Association is the largest nat of state and local associations of apartment industry professionals including developers, owners, investors and property managers. NAA is comprised of 150 affiliates and represents more than 25,000 professionals who own and/or manage more than 3.3 million apartments.

Job creation, an expanded economy, and the efficient flow of capital are often stated as the principal reasons for lowering the rate of capital gains taxation. To achieve these goals, it is necessary to provide a broad-based reduction in the tax. Using Department of Commerce data, it has been estimated by the National Association of Realtors that 27 new jobs are created for every \$1 million spent in upgrades to commercial and residential buildings. At present, many needed upgrades are not occurring because of the "lock-in" effect caused by the lack of flow of capital to various real estate properties where existing investors are unable to sell to new investors because of the high rate of the capital gains tax.

A recent study by the firm of Price Waterhouse LLP shows that a majority of real estate will remain locked-in if previously taken depreciation must be recaptured at the current capital gains rate of 28 percent. This study analyzed the price that an owner received for selling a building after 1994 with the price the owner had earlier paid to acquire the building at some time after 1985. The Price Waterhouse data shows, "60 percent of multifamily buildings sold for less than the owners had paid for them earlier, and the median decline was 30 percent." Obviously a change in tax law that would place real estate at a disadvantage versus other investments would significantly reduce any hoped for benefits of job creation from the reduction of capital gains taxes.

Tax policy arguments are equally compelling for not subjecting previously taken real estate depreciation to any tax rate that is inconsistent with the capital gains tax rate. On March 11, 1997, the E&Y Kenneth Leventhal Real Estate Group of Ernst & Young LLP prepared a Tax Policy Memorandum and Executive Summary on the Tax Policy Arguments for Full Capital Gains Tax Relief for Real Estate. The significant points of this memorandum are summarized as follows:

EXECUTIVE SUMMARY

TAX POLICY ARGUMENTS FOR FULL CAPITAL GAINS TAX RELIEF FOR REAL ESTATE

Background

During last year's budget negotiations and presidential campaign, options were explored to change current tax policy regarding recapture of depreciation on sales of real estate as part of a broad-based capital gains tax relief proposal. Under current law, all gain on the sale of investment real estate is taxed as capital gain unless accelerated depreciation is taken; only the excess of accelerated over straight-line depreciation ("excess depreciation") is "recaptured" and taxed at ordinary income rates. Some recent broad-based capital gains tax relief proposals would lower the capital gains tax rate on sales of real estate only for sales price in excess of original cost. The tax rate on the gain attributable to previously deducted straight-line depreciation would not be reduced, and the gain attributable to current law excess depreciation would remain subject to tax at full ordinary income rates.

Conclusions

We have conclusions concerning broad-based capital gains tax relief proposals that do not offer full capital gains tax relief for sales of real estate:

1. These proposals ignore the fact that real estate is a long-lived wasting asset, and a sale of depreciable real estate is a sale of only what remains of the original asset, not of that which has wasted away. Any gain from a sale of the remaining asset—to the extent not created by excess depreciation deductions—is of a nature properly subject to full capital gain treatment.

2. The current tax policy of taxing only excess depreciation at ordinary rates, and taxing gains due to inflation and other economic factors at full capital gain rates, is the only tax policy that maintains horizontal equity in taxation among competing capital investments. Any effort to provide broad-based capital gains tax relief should as a matter of tax policy fully include the elements of capital gain inherent in sales of depreciable real estate—gains due to inflation and other economic factors—in order to maintain horizontal equity among competing forms of capital investment.

3. It would be inappropriate to change the definition of excess depreciation in a manner that would take away incentives previously offered by Congress to owners of ACRS real property. However, should Congress decide to change the computation of excess depreciation for these assets, it should do so only for depreciation deductions taken after enactment of an amending statute, as Congress has done every time it has changed the recapture rules in the past.

4. The combination of indexing with any broad-based capital gains relief proposal that changes current depreciation recapture tax policy highlights the inequities of denying full capital gain tax relief to sales of real estate. Considering that real estate would have its economic gains in excess of inflation taxed at 28% to the extent of previous straight-line depreciation taken, real estate would be at a serious and obvious disadvantage compared to other investments. Basis indexing combined with capital gains tax relief would not correct the inequity that changes in depreciation recapture tax policy would cause.

TAX POLICY ARGUMENTS FOR FULL CAPITAL GAINS TAX RELIEF FOR REAL ESTATE

I. Introduction

In the past year, there has been some discussion as well as some actual legislative proposals to change current tax policy regarding recapture of depreciation on sales of real estate as part of a broad-based capital gains tax relief proposal. These proposed changes to current tax policy seem largely the result of unsound tax policy arguments designed primarily to lower the cost of a capital gains tax bill. These kinds of broad-based capital gains tax relief proposals would lower the capital gains tax rate on sales of real estate only for sales price in excess of the tax rate on the gain equal to previously deducted straight-line depreciation would not be reduced, and the gain attributable to current law excess depreciation would remain subject to tax at full ordinary income rates.

This paper examines the current tax policy applicable to sales of real estate—taxing only excess depreciation at ordinary rates, and taxing gains due to inflation and other economic factors at full capital gain rates—and demonstrates that these tax policy considerations mandate retention of full capital gain treatment for gains from the sale of real estate (in excess of current law IRC § 1250 recapture) in the context of a broad-based capital gains tax relief proposal in order to preserve horizontal equity in taxation among competing capital investments. This paper also examines basis indexing, and demonstrates that combining basis indexing with a broad-based

capital gains tax relief bill that does not provide full capital gains tax relief for real estate would not solve this fundamental issue of horizontal equity, but would in fact highlight it.

II. Depreciation—Real Estate as a Wasting Asset

IRC § 167 allows taxpayers as a depreciation deduction an allowance for “exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business.” Real estate is properly included in those assets subject to the allowance for depreciation due to its wasting nature.¹

The allowance for depreciation is one of the oldest standing tax provisions, first appearing in the Corporation Tax Act of 1909.² The purpose of the statute is to create a fund to restore the property to the extent of the investment of the taxpayer at the end of its useful life.³ The Supreme Court has stated that “the theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired.”⁴ Because of the difficulty of attributing to each article sold or to the sales in a taxable year an exact sum representing the proportion of basic value of machinery, buildings, patents, etc., entering into such sale, the statutes have consistently provided for a reasonable allowance.⁵ Accordingly, it has never been necessary to conduct an exhaustive engineering study to determine just how much a building has wasted during the year in order to claim a deduction for depreciation.

It is instructive to consider the fundamental distinction between the taxation of depreciation and appreciation with respect to a given asset. This important distinction was eloquently discussed in the *Even Realty* case: There is no reason why wear and tear, purely intrinsic matters, need be tied up to appreciation resulting from extrinsic causes. The two can go on simultaneously and no provision of law requires the one to be offset against the other.

The above discussion summarizes the tax policy behind the allowance for depreciation. This allowance is meant to approximate the degree to which a depreciable asset has wasted away over time. The deduction for depreciation for real estate is properly allowed against ordinary income because it is incurred in producing ordinary income. The courts have recognized that a sale of a depreciable asset is a sale of only what remains of the original asset purchased or constructed, not of that which has wasted away. This remaining asset may be subject to economic factors which increase or decrease its value, but that does not in any way suggest the asset did not physically deteriorate. Such increases or decreases in value of the remaining asset are of a nature normally subject to capital gain treatment. Current tax policy properly recognizes that real estate has an operational aspect (the production of ordinary income) and a capital aspect (the eventual sale of the remaining asset), and taxes each aspect accordingly: the operational aspect is taxed at ordinary rates and the capital aspect is taxed at capital gain rates.

It is this deduction against ordinary income and the corresponding basis adjustment to the remaining capital asset which gives rise to the potential for converting ordinary income into capital gain when depreciation deductions are excessive. The depreciation recapture rules were enacted to address the concept of excess depreciation.

III. COMPONENTS OF TAXABLE GAIN ON THE SALE OF DEPRECIATED REAL ESTATE

A. In General

When depreciated real estate is sold at a price in excess of its adjusted tax basis, the gain can be broken down into three distinct components:

- Gains caused solely by excess depreciation,
- Inflationary gains, and
- Gains due to other economic factors.

The first component, gains created solely by excess depreciation, is properly taxable at ordinary income rates. The second two elements, gains due to inflation and other economic factors, are properly taxable at full capital gain rates, not just for real estate but for all capital investments. This has been the tax policy embodied

¹See *Even Realty Co. v. Comm.*, 1 BTA 355 (1925).

²1909 Act, Sec 38.

³*Detroit Edison Co. v. Comm.*, 131 F2d 619 (CA6 1942), *affd* 319 US 98, 87 L Ed 1286, 63 Ct 902 (1963).

⁴*United States v. Ludey*, 274 U.S. 295 (1927).

⁵*Even Realty Co. v. Comm.*, *supra*, page 359.

in IRC § 1250 for the past 32 years, and remains the only viable tax policy today for sales of depreciable real estate that puts real estate on a parity with competing investment vehicles.

B. Excess Depreciation

Currently, IRC § 1250 defines “additional depreciation” for sales of real estate, which is subject to tax at ordinary rates. In general, “additional depreciation” subject to recapture under IRC § 1250 is equal to the lesser of a) the excess of depreciation taken over straight line or b) the gain on sale. Excess depreciation is a concept unique to depreciable assets as compared with other forms of capital investment. Arguably, various depreciation methods afforded taxpayers over time have allowed for depreciation in excess of “actual” wear and tear, and to the extent this is the case, tax policy should not allow capital gain treatment of gain resulting solely from excess depreciation. IRC § 1250 is merely a correction to the measurement of the operational aspect of real estate from a tax policy standpoint.

The potential for excess depreciation does not exist with respect to nondepreciable capital investments, but there is the potential for “under amortization” of market discount (as opposed to original issue discount) on a bond that gives rise to ordinary income “recapture” to the extent this under amortization is realized at sale or maturity.⁶ Both recapture provisions—the excess depreciation recapture provision applicable to depreciable real estate, and the accrued market discount re to discount bonds—can be said to properly prevent the conversion of ordinary income into capital gains, thereby preserving parity in taxation among competing investments.

1. IRC § 1245—*The Revenue Act of 1962*

The historical debate surrounding the enactment of IRC § 1245 highlights the distinctions between the various elements of gain from the sale of real estate, and shows that this code section is the product of careful deliberation and thoughtful public testimony. First proposed in 1961, IRC § 1245 originally included real estate along with personal property as an asset subject to full depreciation recapture upon sale.⁷

However, testimony before the Ways and Means Committee demonstrated that IRC § 1245 as originally proposed would inappropriately tax major components of gains on the sale of real estate. For instance, it was pointed out that “the forces of inflation and market action inevitably result in prices which are usually in excess of [adjusted] basis,”⁸ and “gains due to factors such as these are generally taxed at capital gains rates.”⁹ In other testimony, it was pointed out that under IRC § 1245 as originally proposed,

“the ordinary income on sale [of real estate] would not be limited to depreciation in excess of that which the taxpayer should have deducted. That could be the case if it’s applied only when the taxpayer had used an unrealistically short life expectancy, or some form of artificial “accelerated” depreciation. Instead, it would apply even if the taxpayer had used straight line depreciation over a conservative life expectancy.

It would therefore apply even though the property has actually depreciated as much as the taxpayer has deducted, and the additional value was attributable to inflation, to change in location, to increased costs of replacement, or to any of the other factors which traditionally create capital gain on property.”¹⁰

“In common with every investor, a builder hopes that his property will increase in value. Such increase may result from negotiation of favorable leases, from economies in management, from adjacent construction or other improvement in the neighborhood, or from a variety of other factors. Such increase in value may also, as we have all learned, represent merely a counteraction against further inflation.”

Leslie Mills, Chairman of the AICPA’s Committee on Federal Taxation in 1961, offered similar testimony about the basic relationship between depreciation and gains on sales of real estate:

“Statutory depreciation, and depreciation in the accounting sense, is not a measure of decline in the value of property, but is a technique for prorating the original cost of property having a useful life extending over a period of years. Changes in

⁶See IRC § 1276 through 1278.

⁷President’s Tax Message, April 20, 1961, page 40.

⁸Statement of Alan J.B. Aronshon, Esq.—1961 Testimony before Ways and Means on the President’s Recommendations on Tax Revision at page 1167.

⁹Id at 1169.

¹⁰Statement of Mark H. Johnson, Representing the Commerce & Industry Association of New York—1961 Testimony before Ways and Means on the President’s Recommendations on Tax Revision at page 1242.

market value of depreciable property are not pertinent factors in determining annual depreciation allowances since the asset is not bought for resale, but for use in the taxpayer's business.

In the case of particular properties, specific circumstances such as opportunities for greater usefulness of the property, changes in economic circumstances, in markets, and so forth, may result in increases in fair market value of the properties. Such gains realized by taxpayers are correctly classified as capital gains since they are not caused by miscalculation of prior depreciation deductions.

In a great many cases, particularly concerning depreciable properties with long useful lives, the increase in value is basically attributable to a decline in the purchasing power of the dollar. We believe that any element of gain which can be attributed to this "inflationary" effect is true capital gain and, consistent with the general philosophy expressed elsewhere in our tax laws, this portion of the gain should not be treated as ordinary income."¹²

Richard Swesnik, Chairman of the Subcommittee of Federal Taxation of the National Association of Real Estate Boards in 1961, offered the following testimony distinguishing the portion of the asset used up versus the portion of the asset sold:

"Depreciation represents the actual wearing out of the asset. It is true that in any one year the rate of actual wear and tear of the property may vary somewhat from the straight line or other rate now permitted by law for computing depreciation. This variation does not justify either the assumption that the asset is not in fact being subjected to wear and tear, or the assumption that the entire amount of the depreciation is an improper deduction which should be recaptured as ordinary income when the property is sold. The property is in fact being used up, and depreciation at some consistent rate should be allowed, even though the remaining property (that is, the property remaining after wear and tear) may be subject to economic factors which vary from year to year, and which may increase or decrease the value of the remaining asset. Gain from the sale of the remaining asset is attributable to these economic factors, and is of the same nature as other gains now subject to capital gains treatment."¹³

Testimony was also presented on administrative expediency and the complexity of separating out gain attributable to non-depreciable land and gain attributable to the depreciable building:

"This committee will recall that, for the period between 1938 and 1942, the tax law experimented with the rule that gain or loss on depreciable property be treated as ordinary income or loss. This committee stated, in introducing the Revenue Act of 1942:

The present law not only results in unfairness to the taxpayer but also in considerable administrative difficulty. For example, if an apartment house is sold, under the present law, it is necessary to separate the land from the building for income tax purposes. This is because the gain allocable to the building is subject to the normal and surtax rates, while the gain allocable to the land is subject to the capital gains rate. *** It is very difficult to allocate the capital gain or loss between the land and the buildings. Accordingly, your committee has changed the rule of existing law, so that both the building, or similar real estate improvements, are treated as capital assets (77th Cong., 2d sess., H. Rept. No. 2333 (1942) 52).

That comment is surely as appropriate today as it was [55] years ago. The present proposal would require the reintroduction of precisely the complication which this committee so sensibly eliminated a long time ago."¹⁴

As a result of this and other testimony, depreciable real property was exempted from full recapture under IRC § 1245. In doing so, the House of Representatives in its report on the Revenue Act of 1962 said "your committee decided not to apply this treatment to buildings or structural components of buildings at this time because testimony before your committee indicated that this treatment presents problems where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period."¹⁵

¹²Statement of Leslie Mills, Chairman, Committee on Federal Taxation, AICPA,—1961 Testimony before Ways and Means on the President's Recommendations on Tax Revision at page 1098.

¹³Statement of Richard Swesnik, Chairman of the Subcommittee of Federal Taxation of the National Association of Real Estate Boards,—1961 Testimony before Ways and Means on the President's Recommendations on Tax Revision at page 1058.

¹⁴Statement of Mark H. Johnson, *supra*, at 1244.

¹⁵House of Representatives Report No. 1447, at page 471.

2. IRC § 1250—The Revenue Act of 1964 and Amending Acts Through 1981

After it was decided to exempt depreciable real estate from full ordinary income recapture in 1962, and apparently in response to the 1961 debate, President Kennedy proposed in 1963 to restrict depreciation methods on real estate to the straight line method, and to recapture depreciation on the sale of real estate in full for property held less than 6 years, on a sliding scale between years 6 and 14, and not at all for property held more than 14 years.¹⁶ Congress did not enact the President's exact proposal, but did in 1964 enact the first recapture provision affecting real estate—IRC § 1250.

In doing so, Congress explicitly recognized that not all depreciation should be subject to ordinary income recapture as a matter of tax policy. Congress said that in 1962, they “did not include real property in the recapture provision applicable to depreciable personal property because [they] recognized the problem in doing so where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period of time. The bill this year [1964] takes this into account. It makes sure that the ordinary income treatment is applied upon the sale of the asset only to what may truly be called excess depreciation deductions. It does this first by providing that in no event is there to be a recapture of depreciation as ordinary income where the property is sold at a gain except to the extent the depreciation deductions taken exceed the deduction which would have been allowable had the taxpayer limited his deductions to those available under the straight line method of depreciation. Secondly, a provision has been added which in any event tapers off the proportion of any gain which will be treated as ordinary income so that it disappears gradually over a 10-year holding period for the real estate. As a result, under the bill, no ordinary income will be realized on the sale of real estate held for more than 10 years.”¹⁷

In 1969, Congress repealed the 10 y for post 1969 depreciation except for low income housing, and lengthened it to 18 years and 4 months from 10 years for new residential housing. In 1976, Congress repealed the burn off of recapture for new residential housing. These and other subsequent amendments were merely adjustments to what Congress felt were accurate measurements of excess depreciation properly subject to ordinary income recapture, but they were not repudiations of the basic tax policy embodied in the original enactment of IRC § § 1245 and 1250.

3. The 1981 Economic and Recovery Tax Act

In 1981, Congress enacted a major overhaul of the depreciation and recapture rules. The purpose behind these changes were stated to be as follows:

“The Congress concluded that prior law rules for determining depreciation allowances and the investment tax credit needed to be replaced because they did not provide the investment stimulus that was felt to be essential for economic expansion. The real value of depreciation deductions allowed under prior rules has declined for several years due to successively higher rates of inflation. Reductions in the real value of depreciation deductions diminish the profitability of investment and discourage businesses from replacing old equipment and structures with more modern assets that reflect recent technology. The Congress agreed with numerous witnesses who testified that a substantial restructuring of depreciation deductions and the investment tax credit would be an effective way of stimulating capital formation, increasing productivity, and improving the nation's competitiveness in international trade. The Congress, therefore, concluded that a new capital cost recovery system was required which provides for the more rapid acceleration of cost recovery deductions and maintains or increases the investment tax credit.”¹⁸

The more generous depreciation deductions granted in 1981 were not accompanied by a tightening of the recapture rules (except for non-residential real property depreciated using the accelerated rates, which was subjected to the § 1245 recapture rules), presumably because as stated above in the committee report the purpose of the 1981 Act was to stimulate the economy. Subjecting this new accelerated depreciation to increased ordinary income recapture would have been counterproductive.

It can be argued that real property depreciated under the rules in effect between 1981 and 1986 have generated excess depreciation in an economic sense, and this excess depreciation should be subject to recapture. However, it was the express intention of Congress that in order to stimulate the economy, Congress would not require recapture of excess depreciation caused by the shortened recovery periods, if

¹⁶Summary of the President's 1963 Tax Message at page 67.

¹⁷Senate Report No. 830 on the Revenue Act of 1964, at page 636.

¹⁸General Explanation of the Economic Recovery Tax Act of 1981, Prepared by the Staff of the Joint Committee on Taxation, 67–86 (12/29/81), page 75.

any. Sound tax policy dictates that once an inducement is offered through the tax code to influence investment decisions, those inducements should remain in place through the life of the investment. Congress should now honor the tax incentives that were offered to these investors to get them to risk their capital at a time when the country was in bad economic straits, and not take them away when times are better, in a large part, due to the investments they made at that time. It should also be noted that every time the recapture rules have been changed in the past, the changes only applied to depreciation deductions taken after the amending statute. The recapture rules have never been changed with respect to deductions already taken.

4. *The Tax Reform Act of 1986 Through the Present*

In 1986, Congress passed the Modified Accelerated Cost Recovery System (MACRS). By virtue of mandating use of the straight-line method of depreciation for real estate placed in service after 1986, there is effectively no depreciation recapture with respect to post-1986 real estate. The lengthening of recovery periods to 27.5 years for residential real estate, and 31.5 years for non-residential real estate (later increased to 39 years in 1993) has arguably eliminated excess depreciation with respect to these assets from an economic standpoint.

5. *Comparison of IRC § 1250 with Personal Property Recapture Rules*

Excess depreciation for personal property is computed differently than for real estate, because personal property has a much shorter useful life, has no non-depreciable component susceptible to inflationary gains (land), and has no provision for salvage value. Accordingly, most (but not necessarily all) of the gain from a sale of personal property is properly considered excess depreciation from a tax policy standpoint, taxable at ordinary rates to the extent of previous depreciation taken.

C. INFLATIONARY GAIN

Any broad-based capital gain tax relief proposal that changes the current tax policy for depreciation recapture on sales of real estate would to a significant degree withhold capital gain tax relief for gains solely attributable to inflation. No comparable provision would exist with respect to the inflationary gains of other forms of investments. Such a proposal would place real estate investment at a competitive disadvantage with other forms of investment to the extent it excludes inflationary gains from full capital gain tax relief.

This type of broad-based capital gain tax relief proposal would exclude a real estate investor's inflationary gains from capital gain tax relief at a time where there is a debate whether to tax these gains at all. On January 26, 1994, current Ways and Means Chairman Bill Archer of Texas introduced the Capital Formation and Jobs Creation Act, which would have indexed the basis of assets for inflation. In introducing this bill, he stated:

"my bill would end the current practice of taxing individuals and corporations on gains due to inflation. Currently, taxpayers must pay capital gains taxes on the difference between an asset's sales price and its basis—the asset's original purchase price, adjusted for depreciation and other items—even though much if not all of that increase in value may be due to inflation. The bill would increase the basis of capital assets to account for inflation occurring after 1994. Taxpayers would be taxed only on the real—not inflationary—gain." [emphasis added]¹⁹

At a time when there is a legitimate debate as to the propriety of taxing illusory inflationary gains from a tax policy standpoint, it makes absolutely no sense to subject the inflationary gains of only one class of investment, real estate, to discriminatory tax rates.

D. GAIN DUE TO ECONOMIC FACTORS OTHER THAN INFLATION

The element of gain from the sale of real estate which is arguably the most difficult to measure of the three economic factors other than inflation—offers the strongest argument for retention of current tax policy regarding depreciation recapture in the context of a broad-based capital gains relief proposal. This paper has demonstrated through careful analysis of pertinent authorities that depreciation relates to the operational aspect of real estate, and that the sale of depreciated real estate—the capital aspect of real estate—is a sale of "not the whole thing originally acquired."²⁰ As to the remaining real estate asset sold, this paper has talked about

¹⁹ Congressional Record entry 7 of 100, January 26, 1994, page E35.

²⁰ See *United States v. Ludey*, *supra*.

the concept of excess depreciation and Congress's attempts over the last 36 years to properly measure this amount, along with the concept of inflationary gain and the ease at which this amount can be measured. Assuming that after 36 years Congress has a pretty good idea of what constitutes excess depreciation, and assuming that the CPI is an accurate measure of relative purchasing power over time, any taxable gain in excess of these first two elements of gain must be an accurate measure of the increase in value of the remaining physical property and land due to other economic factors, as measured by the free market. The only method of taxation of this element of gain that preserves horizontal equity in the taxation of income among competing capital investment vehicles is taxation at full capital gains rates.

Economic factors which commonly add to the value of depreciated real estate include the following:

- Negotiation of favorable leases
- Scarcity of comparable development sites
- Adjacent development / improvement of the neighborhood
- Improvement of market demographics
- Increased replacement costs
- Economies in management
- Infrastructure improvements

These and other economic factors which typically increase the value of the remaining asset can be categorized into two broad categories: favorable market trends and strong management. The values of other forms of capital investment are subject to these same market forces, yet the resulting increments in value are taxed at full capital gains rates. It would be unfair and discriminatory to enact a broad-based capital gains tax relief proposal that would tax the gains of real estate due to these types of economic factors any differently than other forms of capital investment, yet some recent proposals would do just that.

IV. BASIS INDEXING IN COMBINATION WITH DEPRECIATION RECAPTURE

One of the broad-based capital gain tax relief proposals introduced last year would have indexed the basis of capital assets for inflation, starting with assets purchased in 2001. This proposal would have reduced capital gains taxes to a top rate of 14%, but would have exempted real estate to the extent of depreciation previously taken not already recaptured under IRC § 1250.

The combination of these two provisions, once fully phased in, would have had the effect of:

- Taxing excess depreciation at full ordinary rates,
- Not taxing inflationary gains at all, and
- Taxing gains due to other economic factors at a discriminatory 28% rate to the extent of depreciation not already recaptured, and at a 14% rate thereafter.

The combination of basis indexing with broad-based capital gains tax relief highlights the inequities of denying full capital gains tax relief to sales of real estate. Considering that other have all of their economic appreciation taxed at the reduced capital gain rate, real estate would be at a serious and obvious disadvantage compared to other investments. Basis indexing would not correct the inequity that a change in depreciation recapture tax policy would cause.

V. CONCLUSION

Sound tax policy dictates that similarly situated taxpayers be treated the same under the tax code. Real estate must compete with other forms of investment for scarce capital, and should not, as a matter of tax policy, be discriminated against by the tax code unless there is a public policy reason to discourage such investment. No such public policy argument has been advanced by those who would change current tax policy regarding depreciation recapture on sales of real estate as part of a broad-based capital gain relief proposal. Rather, the rationale behind such a policy change seems to be to lower the cost of a broad-based capital gains relief proposal, at the expense of real estate and sound tax policy. Any effort to provide broad-based capital gains tax relief should as a matter of tax policy fully include the elements of capital gain inherent in sales of depreciable real estate -gains due to inflation and other economic factors -in order to maintain horizontal equity among competing forms of capital investment."

CONCLUDING STATEMENT

The economic evidence noted by Price Waterhouse LLP and the strong reasons for retaining present tax policy as advanced by Ernst & Young LLP give clear and compelling arguments for including real estate fully in any broad-based capital gains tax reduction legislation. A fair capital gains tax cut, that neither discriminates against real estate nor against existing investments in favor of new investments, would unlock real estate capital and bring in new investment for job creation. Through the redeployment of existing capital, real estate assets will more likely be recapitalized and reengineered for a very dynamic and fast-changing marketplace.

Present federal tax law recognizes the key difference between rapidly wasting assets like fork-lift trucks and stamping machines, and longer-lived assets such as an apartment building. In the one case, there is little, if any, value left when a piece of machinery is sold. In the case of real estate, the remaining value is primarily due to an increase in land value, the extrinsic value of the property, and the long-term rate of inflation. Thus previously taken building depreciation should not be “recaptured” at ordinary income rates or at 28 percent if the capital gains tax rate is reduced below 28 percent; the capital gains tax rate should be applied to the full gain above adjusted basis.

Three reasons are usually given by those who favor changing the recapture No. 1: “We need the \$7–10 billion this would raise in order to help fund the reduction in capital gains tax rates.” Justification No. 2: “Since real estate now pays a 28 percent capital gains tax rate, its taxes would not be going up. They have not lost anything. No harm, no foul.” Justification No. 3: “Real estate has an unfair advantage versus investment in machinery and equipment.”

Let’s take the argument that more money is needed to help pay for the capital gains tax cut and juxtapose this with the argument that there is “no harm, no foul.” Anything that brings in \$10 billion must have some economic bite. If changing the depreciation recapture rules for real estate brings in this much, it will all but negate any benefit of a capital gains tax reduction; the Price Waterhouse study shows this to be true. Real estate overall has not appreciated considerably in value and thus would remain “locked-in” by a capital gains tax cut that includes full real estate depreciation recapture at 28 percent or higher.

Looking forward, a change in the recapture rules would place real estate investment at a significant disadvantage compared to other investments. So there indeed is a “foul” caused by changing the rules. Finally, the so-called double standard argument that compares machinery to buildings is inappropriate. The fact is there is not a tax policy fairness problem to begin with, since these are two fundamentally different assets. Real estate is a long-lived wasting asset. Any gain upon sale does not result from having taken depreciation in prior years.

Most real estate is held for longer periods of time, has not appreciated significantly in value, and is still held primarily by individual investors. The vast majority of investors and properties would not receive any benefit from a capital gains tax cut that has a depreciation recapture provision.

A broad-based reduction in capital gains taxes would clearly benefit investors and free up dollars for new investment. However, the use of the term “broad-based” should be discontinued if the proposal also includes a change in the depreciation recapture rules that would tax previously taken depreciation at a non-capital gains tax rate. That type of legislation is truly not broad-based and might cause significant harm to future real estate values. For tax policy reasons and sound economic reasons, a broad-based cut in the capital gains tax that does not change the recapture rules should be the proposal that our lawmakers pursue.

Statement of Patrick Brennan, Vice President, Pericom Semiconductor Corp., San Jose, California; on Behalf of the R&D Credit Coalition

Mr. Chairman and members of the Committee, my name is Patrick Brennan, and I am the Vice President of Pericom Semiconductor Corporation of San Jose, California. I thank you for the opportunity to submit this statement on behalf of the R&D Credit Coalition on the importance of making permanent the research and experimentation tax credit (commonly referred to as the "R&D" credit), as recently modified by the Small Business Job Protection Act of 1996. The R&D Credit Coalition is a broad-based coalition of eighteen trade associations and approximately 600 small, medium and large companies, all united in seeking the permanent extension of the R&D credit. The members of the R&D Credit Coalition represent many of the most dynamic and fastest growing companies in the nation and include the entire spectrum of R&D intensive industries: aerospace, biotechnology, chemicals, electronics, information technology, manufacturing, pharmaceuticals and software. (I have attached to this statement a letter from the members of the R&D Credit Coalition to President Clinton concerning including the R&D credit in the Administration's FY 1998 Budget.)

Pericom Semiconductor Corporation, founded in 1990, is a privately owned semiconductor company located in San Jose, California. The company designs, develops and markets high performance digital and mixed signal integrated circuits for the personal computer, workstation, peripherals and networking markets. Pericom's expertise in design and system technologies has created over 200 products and the company delivers large quantities of vital components to major customers worldwide. Rapid new product development is essential to success in our industry. Pericom's advanced design and engineering expertise and continued commitment to research and development provides users with innovative products which offer immediate measurable benefits. The company has grown to over 125 employees and spends approximately 15% of each revenue dollar on research and development of new products. The company is an ISO registered facility and is recognized for the quality of its products.

I want to commend Representatives Nancy Johnson and Bob Matusi, and the original cosponsors of H.R. 947, and Senators Hatch and Baucus, and the original cosponsors of S. 405, for introducing legislation to permanently extend the R&D credit, as enacted last year in the Small Business Job Protection Act of 1996. Senators Gramm and Hutchinson are also to be commended for introducing legislation (S. 355) to permanently extend the R&D credit. I also want to commend President Clinton for including, and funding, an extension of the R&D tax credit, as enacted in the Small Business Job Protection Act, in the Administration's FY 1998 Budget.

I hope the Congress will take swift action to permanently extend the R&D credit by enacting the provisions of H.R. 947—S. 405 before the credit expires once again on May 31, 1997.

I. R&D CREDIT LEGISLATIVE HISTORY

The R&D credit was enacted in 1981 to provide an incentive for companies to increase their U.S. R&D activities. As originally passed, the R&D credit was to expire at the end of 1985. Recognizing the importance and effectiveness of the provision, Congress decided to extend it. In fact, since 1981 the credit has been extended seven times. In addition, the credit's focus has been sharpened by limiting both qualifying activities and eligible expenditures, and altering its computational mechanics. The credit has been the focus of significant legislative activity and has undergone refinement many times since its inception.

In 1986, the credit lapsed, but was retroactively extended and the rate cut from 25 percent to 20 percent. In 1988, the credit was extended for one year. However, the credit's effectiveness was further reduced by decreasing the deduction for R&D expenditures by 50% of the credit. In 1989, Congress extended the credit for another year and made changes that were intended to increase the incentive effect for established as well as start-up companies. In the 1990 Budget Reconciliation Act, the credit was extended again for 15 months through the end of 1991. The credit was again extended through June 30, 1992, by the Tax Extension Act of 1991. In OBRA 1993, the credit was retroactively extended through June 30, 1995.

In 1996, as part of the Small Business Job Protection Act of 1996, the credit was extended for eleven months, through May 31, 1997, but was not extended to provide continuity over the period July 1, 1995 to June 30, 1996. This one-year period, July 1, 1995 to June 30, 1996, was the first gap in the credit's availability since its enactment in 1981. In 1996, the elective Alternative Incremental Research Credit ("AIRC") was added to the credit, expanding the availability of the credit to R&D intensive industries which could not qualify for the credit under the regular criteria.

The AIRC adds flexibility to the credit to address changes in business models and R&D spending patterns which are a normal part of a company's life cycle.

According to the Tax Reform Act of 1986, the R&D credit was originally limited to a five-year term in order "to enable the Congress to evaluate the operation of the credit." While it is understandable that the Congress in 1981 would want to adopt this new credit on a trial basis, the credit has long since proven over the sixteen years of its existence to be an excellent investment of government resources to provide an effective incentive for companies to increase their U.S.-based R&D.

The historical pattern of temporarily extending the credit, combined with the first gap in the credit's availability, has reduced the incentive effect of the credit. The U.S. research community needs a stable, consistent R&D policy in order to optimize its contribution to the nation's economic growth and sustain the basis for ongoing technology competitiveness in the global arena.

II. WHY DO WE NEED A R&D CREDIT?

A. *Credit offsets the tendency for under investment in R&D*

The single biggest factor behind productivity growth is innovation. As stated by the Office of Technology Assessment in 1995: "Much of the growth in national productivity ultimately derives from research and development conducted in private industry." Sixty-six to eighty percent of productivity growth since the Great Depression is attributable to innovation. In an industrialized society R&D is the primary means by which technological innovation is generated.

Companies cannot capture fully the rewards of their innovations because they cannot control the indirect benefits of their technology on the economy. As a result, the rate of return to society from innovation is twice that which accrues to the individual company. This situation is aggravated by the high risk associated with R&D expenditures. As many as eighty percent of such projects are believed to be economic failures.

Therefore, economists and technicians who have studied the issue are nearly unanimous that the government should intervene to bolster R&D. A 1994 study, *Extending the R&D Credit: The Importance of Permanence* (November 1994), conducted by the Policy Economics Group of KPMG Peat Marwick, concluded that "...[A] tax credit for research and experimentation was enacted with the goal of offsetting the tendency to under invest in industrial research. The R&D tax credit has been an effective-and cost-effective tool for stimulating private R&D activity." Stimulating private sector R&D is particularly critical in light of the decline in government funded R&D over the years. Direct government R&D funding has declined from 57% to 36% of total R&D spending in the U.S. from 1970 to 1994. Over this same period, the private sector has become the dominant source of R&D funding, increasing from 40% to 60%.

B. *The credit helps U.S. business remain competitive in a world marketplace*

The R&D credit has played a significant role in placing American businesses ahead of their international competition in developing and marketing new products. It has assisted in the development of new and innovative products; providing technological advancement, more and better U.S. jobs, and increased domestic productivity and economic growth. This is increasingly true in our knowledge and information-driven world marketplace.

Research and development must meet the pace of competition. In many instances, the life cycle of new products is continually shrinking. As a result, the pressure of getting new products to market is intense. Without robust R&D incentives encouraging these efforts, the ability to compete in world markets is diminished.

Continued private sector R&D is critical to the technological innovation and productivity advances that will maintain U.S. leadership in the world marketplace. Since 1981, when the credit was first adopted, there have been dramatic gains in R&D spending. Unfortunately, our nation's private sector investment in R&D (as a percentage of GDP) lags far below many of our major foreign competitors. For example, U.S. firms spend (as a percentage of GDP) only one-third as much as their German counterparts on R&D, and only about two-thirds as much as Japanese firms. This trend must not be allowed to continue if our nation is to remain competitive in the world marketplace.

Moreover, we can no longer assume that American companies will automatically choose to site their R&D functions in the United States. Foreign governments are competing intensely for U.S. research investments by offering substantial tax and other financial incentives. An OECD survey of sixteen member countries found that thirteen offer R&D tax incentives. Of the sixteen OECD nations surveyed, twelve provide a R&D tax credit or allow a deduction for more than 100% of R&D expenses.

Six OECD nations provide accelerated depreciation for R&D capital. According to the OECD survey, the U.S. R&D tax credit as a percentage of industry-funded R&D was third lowest among nine countries analyzed. Even without these tax incentives, the cost of performing R&D in many foreign jurisdictions is lower than the cost to perform equivalent R&D in the U.S. In light of this international trend, Congress and the Administration must make a strong and permanent commitment to attracting and retaining R&D investment in the United States. The best way to do that is to permanently extend the R&D credit.

C. The credit provides a targeted incentive for additional R&D investment, increasing the amount of capital available for innovative and risky ventures.

The R&D credit reduces the cost of capital for businesses that increase their R&D spending, thus increasing capital available for risky research ventures.

Products resulting from R&D must be evaluated for their financial viability. Market factors are providing increasing incentives for controlling the costs of business, including R&D. Based on the cost of R&D, the threshold for acceptable risk either rises or falls. By reducing the costs of R&D, you make it possible to increase R&D efforts. In most situations, the greater the scope of R&D activities, or risk, the greater the potential for return to investors, employees and society at large.

The R&D credit is a vital tool to keep U.S. industry competitive because it frees-up capital to invest in leading edge technology and innovation. It makes available additional financial resources to companies seeking to accelerate research efforts. It lowers the economic risk to companies seeking to initiate new research, which will potentially lead to enhanced productivity and overall economic growth.

D. Private industrial R&D spending is very responsive to the R&D credit, making the credit a cost effective tool to encourage economic growth

Economic studies of the credit, including the KPMG Peat Marwick 1994 study referenced above, and B. Hall, "R&D Tax Policy in the 1980s: Success or Failure?" Tax Policy and the Economy (1993), have found that a one-dollar reduction in the after-tax price of R&D stimulates approximately one dollar of additional private R&D spending in the short-run, and about two dollars of additional R&D in the long run. That in turn, implies long-run growth in GDP. In addition, the KPMG Peat Marwick study concluded, "The credit has been a public policy success... The best available evidence now indicates that the increase in R&D due to the tax credit equal or exceed the credit's revenue costs."

E. Research and Development is About Jobs and People

Investment in R&D is ultimately an investment in people, their education, their jobs, their economic security, and their standard of living. Dollars spent on R&D are primarily spent on salaries for engineers, researchers and technicians.

When taken to market as new products, incentives that support R&D translate to salaries of employees in manufacturing, administration and sales. Of exceptional importance to Pericom Semiconductor Corporation and the other members of the R&D Credit Coalition, R&D success also means salaries to the people in our distribution channels who bring our products to our customers as well as service providers and developers of complementary products. And, our customers ultimately drive the entire process by the value they put on the benefit to them of advances in technology. Benefits that often translate into improving their ability to compete. By making other industries more competitive, research within one industry contributes to preserving and creating jobs across the entire economy.

My experience has been that more than 75 percent of expenses qualifying for the R&D credit go to salaries for researchers and technicians, providing high-skilled, high-wage jobs to U.S. workers. Investment in R&D, in people working to develop new ideas, is one of the most effective strategies for U.S. economic growth and competitive vitality.

F. The R&D credit is a market driven incentive

The R&D credit is a meaningful, market-driven tool to encourage private sector investment in research and development expenditures. Any taxpayer that increases their R&D spending and meets the technical requirements provided in the law can qualify for the incentive. Instead of relying on government-directed and controlled R&D spending, businesses of all sizes, and in all industries, can best determine what types of products and technology to invest in so that they can ensure their competitiveness in the world marketplace.

III. THE R&D CREDIT SHOULD BE MADE PERMANENT TO HAVE OPTIMUM INCENTIVE EFFECT

Research projects cannot be turned off and on like a light switch. If corporate managers are going to take the benefits of the R&D credit into account in planning future research projects, they need to know that the credit will be available to their companies for the years in which the research is to be performed. Research projects have long horizons and long gestation periods. Furthermore, firms generally face longer lags in adjusting their R&D investments compared, for example, to adjusting their investments in physical capital.

In order to increase their R&D efforts, businesses must search for, hire, and train scientists, engineers and support staff. They must often invest in new physical plant and equipment. There is little doubt that a portion of the incentive effect of the credit has been lost over the past seventeen years as a result of the constant uncertainty over the continued availability of the credit.

If the credit is to provide an effective incentive for increased R&D activity, the practice of periodically extending the credit for short periods, and allowing it to lapse, must be eliminated, and the credit must be made permanent. Only then will the full potential of its incentive effect be felt across all the sectors of our economy.

IV. CONCLUSION

Making the existing R&D credit permanent best serves the country's long term economic interests as it will eliminate the uncertainty over the credit's future and allow R&D performing businesses to make important long-term business decisions regarding research spending and investment. Private sector R&D stimulates investment in innovative products and processes that greatly contribute to overall economic growth, increased productivity, new and better U.S. jobs, and higher standards of living in the United States. Moreover, by creating an environment favorable to private sector R&D investment, jobs will remain in the United States. Investment in R&D is an investment in people. A permanent R&D credit is essential for the United States economy in order for its industries to compete globally, as international competitors have chosen to offer direct financial subsidies and reduced capital cost incentives to "key" industries. The R&D Credit Coalition strongly supports the permanent extension of the R&D credit and urges Congress to enact the provisions of H.R. 947—S. 405 before the credit expires on May 31, 1997.

Attachment: Letter from members of R&D Credit Coalition to President Clinton

December 18, 1996

The Honorable William Jefferson Clinton
President of the United States
The White House
Washington, D.C. 20500

Dear Mr. President:

We urge you to include a permanent extension of the Research and Experimentation tax credit (commonly referred to as the R&D Credit), as recently enacted in the Small Business Job Protection Act, including the elective alternative incremental research credit, in your Fiscal Year 1998 Budget. As you know, the R&D Credit was allowed to lapse for the first time since its inception and is set to expire again in only a few short months; it is now more critical than ever that your Administration demonstrate its continuing commitment to the R&D Credit by including, and funding, a permanent extension in your FY 98 Budget.

The R&D Credit enjoys broad, bipartisan support and provides a critical, effective and proven incentive for companies to maintain and increase their investment in U.S. based research and development. The continued encouragement of private sector R&D is particularly important in light of the substantial tax and other financial incentives offered by many of our major foreign trade competitors and the budgetary pressures to reduce Federal Government investment in basic and applied research. Moreover, targeted primarily at salaries and wages paid to employees engaged in U.S.-based R&D activities, the credit supports the creation of valuable new, high-skilled jobs for American workers.

For these reasons, we strongly urge you to make an investment in the future economic growth of our country by funding a permanent extension of the R&D Credit in your FY 98 Budget.

We thank you for your consideration of our strong interest in a permanent R&D Credit and look forward to working with you toward this goal.

Sincerely,

(ATTACHED SIGNATORIES)

cc: Honorable Robert E. Rubin
 Honorable Franklin D. Raines
 Honorable Erskine Bowles

Aerospace Industries Association of America, Inc.
 American Automobile Manufacturers Association
 American Electronics Association
 Biotechnology Industry Organization
 Business Software Alliance
 Chemical Manufacturers Association
 Computing Technology Industry Association
 Electronic Industries Association
 Information Technology Association of America
 Information Technology Industry Council
 National Association of Manufacturers
 Pharmaceutical Research & Manufacturers of America
 Semiconductor Equipment and Materials International
 Software Publishers Association
 Telecommunications Industry Association
 U.S. Chamber of Commerce
 US Telephone Association
 Utah Information Technologies Association
 3Com Corporation
 3M Company
 3M Health Information Systems
 Abbott Laboratories, Inc.
 Absolute Time Corporation
 Academedia Multimedia Solutions
 AccelGraphics
 Accel Technologies, Inc.
 Access The West
 AccSys Technology, Inc.
 Accurel Systems International Corporation
 ACT Teleconferencing
 Active Power
 Action Instruments, Inc.
 Aadastra Systems Corporation
 Adobe Systems, Inc.
 Advanced Energy Industries, Inc.
 Advanced Micro Devices, Inc.
 Advance Technology, Inc.
 Advent Systems, Inc.
 AG Associates
 Air Products and Chemicals, Inc.
 Airtouch Cellular
 Alcatel NA Cable Systems, Inc.
 Alex Systems
 Allen Communication
 Alliance Semiconductor Corporation
 Allied Signal
 Alpnet, Inc.
 America-Net
 American Computer Hardware Corporation
 American Home Products Corporation
 American Telecorp, Inc.
 Ameritech Library Services
 Amgen, Inc.
 AMP
 Analogic, Inc.
 Ancestry, Inc.

Angle Technologies, Inc.
Apple Computer, Inc.
Applied Computer Techniques, Inc.
Applied Materials
Arcanvs, Inc.
Arcom Architectural Computer Services
Artnet
Asante' Technologies, Inc.
Ashton, Harker, Bingham, Inc.
Associates & Blair
Associated Components Technology, Inc.
Astra USA, Inc.,
AT&T
AT&T Wireless Services
Atmel Corporation
Attachmate Corporation
Autocon, Inc.
Autodesk, Inc.
Autosimulations, Inc.
Auto-Soft Corporation
Autosplice, Inc.
Avid Technology, Inc.
Axiom Technologies, L. C.
Aztek Engineering, Inc.
Banyan Systems, Inc.
Bay Networks, Inc.
Bell Atlantic
Bell & Howell Lightspeed
Berger & Co.
Best Consulting
BFGoodrich Company
BI Incorporated
Bison Group
BMC Software, Inc.
Boehringer Ingelheim Pharmaceuticals, Inc.
Bolder Technologies Corporation
Bolt Beranek & Newman
Bonneville International Corporation
Borland International
Boston Technology, Inc
Bristol-Myers Squibb Company
Broderbund Software, Inc.
Burton Group
Bybee Printed Circuit Design
C-COR Electronics Inc.
Caldera, Inc.
Calex
California Healthcare Institute
California Instruments Corporation
Calimetrics, Inc.,
Call Business Systems, Inc.
Call Dynamics
Callware Technologies
Cambic Graphics, Inc.
Cambridge Technology Partners, Inc.
Candescent Technologies Corporation
Capssoft Development Corporation
Carco Electronics
Carlisle Wilkins, L.C.
Cartwright Communications
Caseware Technology, Inc.
Catapult Communications
CASCADE Communications Corp.
CDI Information Services, Inc.
Centre Technologies
Centric Engineering Systems, Inc.
Century Software
Certified Management Software, Inc.

Charles Industries, Ltd.
CHI Squared Software, Inc.
Chrysler Corporation
Circuit Technology Corp.
Cirque Corporation
Cirris Systems Corporation
Cisco Systems, Inc.
Citizens Telecom
Citrix Systems, Inc.
Claris Corporation
Clark Development Company, Inc.
Codar Technology, Inc.
Cognex Corporation
Coherent Technologies,
Coleman's
Companion Corporation
COMPAQ Computer Corporation
Compass Data Systems, Inc.
Computer Consultants Corporation
Computer Management Systems, Inc.
Computer Sciences Corporation
Computer Task Group, Inc.
Comspec Corporation
Connecting Point Computer Center
Connective Solutions, LLC
Consultnet
Copley Controls
Corel, Inc.
Correct Knowledge
Cray Research, Inc.
Create-A-Check, Inc.
Creative Computer Solutions, Inc.
Creative Insight, Inc.
Creative Media
Crystal Canyon Interactive
Cyberamerica
CyberSym Technologies
Cygnum Solutions
Darbick Instructional Software Systems
Data Systems International
Dataflow Services
Datamatic, Inc.
Dataware Technology
Datum Inc.
Dayna Communications, Inc.
Decision Systems Technologies, Inc.
Desktop Visual Products
Digital Equipment Corporation
Digital Radio Communications Corp.
Digitran Systems, Inc.
Digivision
Dimensions/Computer Advisors, Inc.
Dionex Corporation
Directell, Inc.
DOCU Prep, Inc.
Document Control Systems
DS Technologies, Inc.
Duplication Group
Dupont Merck Pharmaceutical Company
DVT Corporation
E. I. Dupont Nemours and Company, Inc.
Eastman Kodak Company
Eckersley Associates DP+R
Edge Semiconductor Incorporated
EDS
EFI Electronics Corporation
Electro Scientific Industries, Inc.
Electronic Cottage

Electronic Decontamination Specialists
Electronic Expressway Connections
Elpac Electronics, Inc.
Embedded Performance, Inc.
EMC Corporation
Engineering Geometry Systems, Inc.
Equis International
Ernest & Young LLP
ESCO Electronics Corporation
Eskay Corporation
Evans & Sutherland Computer Corporation
Expersoft
Eyring Corporation
Fiber Optic Technologies, Inc.
Fibernet
FileNet Corporation
Fisher Berkeley Corporation
Floppy Copy, Inc.
Folio Corporation
Ford
Four Corners Technology, Inc.
Franklin Estimating Systems
Frequency Products
FTP Software, Inc.
Future Active Industrial Electronics
Galapagos Software, Inc.
GECAP
Genentech, Inc.
General Dynamics Corporation
General Motors Corporation
Genetics Institute
GENZYME CORPORATION
Geometrics, Inc.
GLASPAC—Total Solutions
Glaxo Wellcome, Inc.
Global Ergonomic Technologies, Inc.
Gold Systems, Inc.
GSE Erudite Software
H. Rel Laboratories, Inc.
Hall-Mark Computer
Harding & Harris Behavioral Research
Harris Corporation
Harry Sello and Associates
Headway Research, Inc.
HEC Software, Inc.
Hemasure, Inc.
HNC Software, Inc.
Hoffman-LaRoche
Home Financial Network, Inc.
Honn Enterprises
Horix Manufacturing Company
Hurricane Electronics Lab., Inc.
Hutchinson Telephone Company
HY-Tech Business Services
IBM Corporation
IC One
ICIS, Inc.
I-EIGHTY
IES, Inc.
Individual, Inc.
Industry West Electronics
Indyme Electronics, Inc.
Infobusiness, Inc.
Infonational, LLC
Information Builders, Inc.
Information Enabling Technologies (IET)
Information Plus Corporation
Information Technologies

Infosphere
Innerworks
Inno Cal
Innovative Telecom
Innovax Concepts Corporation
Innovus Multimedia, Inc.
Insight Software Solutions, Inc.
Inso Corporation
INSTRON Corporation
INTA
Intel Corporation
Intelli Media, Inc.
Intelliquest Technologies, Inc.
Intellitrends
Interactive Services
Interated Systems, Inc.
Interconnect West
Interim Technology
Interlake Software Solutions
Interlynx Technology Corporation
Internet Magic, Inc.
Intuit Inc.
InVINCIBLE Enterprises
I-O Corporation
IOMEGA Corporation
IPM/Management 2000, LC
I*SLM Corporation
ITC Companies
ITPARTNERS, Inc.
J. R. Firestack & Associates
Jason Associates Corporation
JH Associates
Johnson & Johnson
Kaiser Electroprecision
KAMP—Data
KCE
Keane, Inc.
Kenex Systems, Inc.
Kenter Information Systems, Inc.
Keylabs, Inc.
Kiva
Kofax Image Products
Komag Inc.
KV Communications, Inc.
Laser Mail
Laser Supply of Utah, Inc.
Laser Systems
Latin Connection, Inc.
Lexmark International, Inc.
Liconix
Lifeline Systems, Inc.
Eli Lilly and Company
Lockheed Martin Tactical Communication Systems
Logic Works, Inc.
Logical Services Incorporated
Loronix Information Systems, Inc.
Lucent Technologies, Inc.
McAfee Associates
McData Corporation
McDonnell Douglas
Macromedia
Majesco Software, Inc.,
Mark Communications
Marketing Ally Teleservices
Marshall Contractors
Maxon America, Inc.
MCI Communications
MCI Telecommunications Corporation

Meeting Ware International, Inc.
Megg Associates, Inc.
Mentor Graphics Corporation
Merck & Company, Inc.
Metastorm, Inc.
Metcam, Inc.
Metronerles Corporation
Micro Automation Enterprise
Micro Choice, Inc.
MicroHelp, Inc.
MicroSim Corporation
Microsoft Corporation
Microsurge, Inc.
Microsystems Software
MIS LABS
Mitel Semiconductor, Inc.
MKS Instruments, Inc.
Monsanto-Searle Company
Motorola
Mountain View Software Corp.
Multiling International, Inc.
Napersoft, Inc.
National Applied Computer Technologies, Inc.
National Semiconductor Corporation
National Software Testing Laboratories
Net Dynamics, Inc.
Nets, Inc.
Netscape Communications, Inc.
NetSoft
Network Centre
Network Computer Systems
Network Information Research Corp.
Network Integration, Inc.
Network Publishing, Inc.
Network Technical Services
New Client Software, Inc.
Newbridge Networks Inc.
Newport Corporation
Northridge Systems, LLC
Northrop Grumman
Northern Telecom Inc.
Novell, Inc.
NYNEX
OEC Medical Systems, Inc.
Omnidata International, Inc.
One-Off CD Shops—Division of Software Duplicators
ONYX Graphics, Corp.
Open Highways, LLC
Optek Technology, Inc.
Optical Data Systems, Inc.
Optionomics Corporation
Oracle Corporation
Organogenesis, Inc.
Ortho-Graphics, Inc.
Oryx Technology Corporation
Outsource Engineering and Manufacturing
Outsource Solutions
Outsource Technologies
Ovid Technologies, Inc.
Oxford & Associates
Pacific Telesis Group
Palomar Systems, Inc.
Paragraph International
Parametric Technology
ParcPlace-Digitalk, Inc.
Park City Group
Pasteur Merieux Connaught
PC Software Systems, LLC

PCD, Inc.
Pembroke's, Inc.
Pen Interconnect, Inc.
Pericom Semiconductor Corporation
Pfizer
Pharmacology Data Management Corporation
Pharmacia & Upjohn
Philips Electronics
Phoenix Fiberlink, Inc.
Phonex Corporation
Pivotpoint, Inc.
Planet Software
Pleiades Software Dev., Inc.
Polatomic, Inc.
PowerQuest Corporation
Power Stream Technology, Inc.
POWERTEX INC.
Pragmatic Data Quest
Precision Assembly, Inc.
Precision Cable Corporation
Premier Laser Systems
Primavera Systems, Inc.
Prime Technological Services, Inc.
Printronic, Inc.
Process Software Corporation
Procoply
Prodigy, Inc.
Programart Corporation
Progressive Solutions, Inc.
Project Software & Development, Inc.
Promodel Corporation
Protel
Prototype & Plastic Mold Co. Inc.
Procter & Gamble Company
Pulizzi Engineering, Inc.
Qlogic Corporation
QLP Laminates
QSI Corporation
Quality Education Data
Quantum Leap
Questar Infocomm, Inc.
R. R. Donnelley & Sons Company
Racore Computer Products, Inc.
Rainbow Technologies, Inc.
RAM Software Systems, Inc.
Rapid, LLC
Raptor Systems, Inc.
Rascom, Inc.
Raster Graphics, Inc.
Raytheon Company
Red Rock Technologies
Redcon, Inc.
Relationship Software, LLC
Reliability Incorporated
Rhyse Development, Inc.
Rockwell International Corp.
Rocky Mountain Hardware Company
Rohm & Haas Company
Router Ware
Saffire Corporation
Salt Lake Cellular
Saville Systems, Inc.
SBC Communications
SBE, Inc.
Schering-Plough Corporation
SCHOTT Corporation
Science Applications International Corp. (SAIC)
Scientific-Atlanta, Inc.

Scientific Technologies, Inc.
Scitex America, Inc.
Scopus Technology, Inc.
Seer Technologies, Inc.
Semiloa Semiconductors
Sepracor, Inc.
Sequent Computer Systems, Inc.
Sequoia Group, Inc.
ShareData Inc
Shelby Industries, Inc.
Silicon Graphics
Silicon Valley Group, Inc.,
Siemens Corporation
Siemens Rolm Communications, Inc.
Sierra Semiconductor
Simates, Inc.
SIMCO Electronics
Singletrac Entertainment Technologies, Inc.
Skipstone, Inc.
SkyHook Technologies, Inc.
Smart Communications
Smartdial/Information Access Technology, Inc.
Smarttalk, Inc.
Smartware Systems, Inc.
SmithKline Beechman Corporation
Softset International, Inc.
Software Forum
Software Development Corp.
Software Magic
Software Publishing Corporation
Software Studios
Solid Design & Analysis, Inc.
Source Services
Spatial Technology Inc.
Spiricon, Inc.
Sprint
SRC Computers, Inc.
Stac, Inc.
Sterling Wentworth Corporation
Storage Technology Corporation
Strata, Inc.
Stratedge Corporation
Strategic Marketing
Stream International, Inc.
Streamlined Information Systems
Stuart & Co.,
Subscriber Computing, Inc.
Summit Consulting Group
Summit Technology, Inc.
Sun Microsystems, Inc.
Sun Remarketing, Inc.
Surfware, Inc.
Sybase, Inc.
Symantec Corporation
Synergy, Inc.
Systems West Computer Resources, Inc.
Tandem Computers Incorporated
Target Software, Inc.
TCG—Teleport Communications Group
TCI Caglelevision Of Utah, Inc.
Teal Electronics Corporation
Technology Advancement Corporation
Technology Sales, Inc.
Tecknowledgez, Inc.
Tekana Corporation
Tel0ecom Strategies, Inc.
Telect, Inc.
Telesensory Corporation

Telesync, Inc.
Tels Corporation
Teltrust, Inc.
Teltrust, Com
Tenth Planet
Teradyne, Inc.
T.H.E., LLC
The Automatic Answer
The Directorate, Inc.
THE LEARNING COMPANY
The VALIS Group, Inc.
The Video Call Company
Theoretics, Inc.
Thiokol Corporation
Thunderbird Technologies, Inc.
Tomax Technologies, Inc.
TRW Inc.
Tranquility Systems
Transoft International, Inc.
Traveling Software
Trebor International
TSI International
U'S West Communications
United Technologies Corporation
Union Carbide Corporation
Unisys Corporation
Unitrode Corporation
Usability Center
Utah Education Network
Utah Scientific, Inc.
Value Added Software, Inc.
Varian Associates
Venture Advisory Group
Venture Engineering Corporation
Verite' Multimedia
Versant Object Technology
Vertex Pharmaceuticals Incorporated
VideoServer, Inc.
Viewpoint Datalabs
Viewsoft, Inc.
Vinca Corporation
Visicon, Inc.
Visio Corporation
Vitrex Corporation
Voicestream Wireless
Voicetek Corporation
VZ Corporation
Wall Data, Inc.
Warever Corporation
Warner-Lambert
Watkins-Johnson Company
Western Digital Corporation
Western Midrange Corporation
Western Telematic, Inc.
Westin Technology Center
Wicat Systems, Inc.
Witel Technology Ventures, Inc.
Wind River Systems
Winward Telecommunications
Wydah Corporation
Xerox Corporation
XILINX, Inc.
Z Microsystems, Inc.
Zebra Technologies VTI, Inc.
ZZ Soft
ZZ Software Systems, Ltd.

Any inquiries concerning this letter may be directed to Donna Siss Gleason, Director, Government Relations, Electronic Industries Association (703) 907-7587.

ADDENDUM

The listed company names below were received after the letter was sent out to the President.

New Image Industries, Inc.
Odetics
Jones & Askew
Racom Systems, Inc.

