



FOR RELEASE UPON DELIVERY
October 22, 1979 10:00 AM EDST

TESTIMONY OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY

BEFORE THE SUBCOMMITTEE OF TAXATION
AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

Thank you for inviting me to discuss S. 1435, a very significant proposal to restructure the system of depreciation allowances. I am pleased to see the broad interest in legislation to encourage capital formation and increase productivity.

The 10-5-3 proposal would restructure the system of tax allowances for capital recovery. It would greatly shorten the periods over which most capital expenditures can be written off. The proposal provides for non-residential buildings to be written off over 10 years, in a pattern so accelerated that 70 percent of the acquisition cost could be deducted in the first 5 years. Expenditures for most machinery and equipment could be fully written off, also in an accelerated pattern, over 5 years. A limited amount of expenditures for cars and light trucks used in businesses would be written off over a three-year period. This proposal would also liberalize the investment tax credit, by allowing the full 10 percent credit (instead of 6 2/3 percent) for equipment depreciated over 5 years, and a 6 percent credit (instead of 3 1/3 percent) for the 3-year class of assets. A phase-in over 5 years is proposed whereby the write-off periods, starting from a 1980 base, are reduced year-by-year. The 1980 lives are determined by reference to the current Asset Depreciation Range (ADR) system. Advocates of 10-5-3 argue that it would promote simplification and certainty, aid small business, and provide incentives for capital expansion. These are laudable goals, and should be considerations in evaluating any tax structure. Evaluation of our current system shows that there is room for improvement.

M-132

Economic Background

The increase of 2.4 percent in real GNP for the third quarter of this year is further indication of strength in the economy, but prices continue to show rapid increase. I want to emphasize that the Administration intends to sustain a firm and consistent policy to reduce inflation. This policy has a number of aspects, but none is more important than the maintenance of strict fiscal discipline. At the present time, the action of steady budget pressure to slow the rate of inflation offers the strongest promise of restoring the health of our economy, reducing economic uncertainty, and reversing expectations for future inflation.

I believe that a commitment to widen the budget deficit by the magnitude of S. 1435 would be premature at this time. However, we should study possibilities for a program that will promote longer-range economic objectives as effectively and fairly as possible. At the appropriate time, you should be prepared to act on a program carefully structured to expand economic capacity, to reduce production costs, and to promote productivity. Appropriate depreciation allowances can help to accomplish these goals and should be given serious consideration as an element of any future tax package.

Revenue Costs of 10-5-3

Looking specifically at the 10-5-3 proposal, I would first point out that it would have a massive budget impact. The cost of S.1435 rises from about \$4 billion in the first year to over \$50 billion in 1984 and over \$85 billion in 1988 (see Table 1).

These estimates have been carried out further into the future than we would normally show in order to see the full effect of the proposed phase-in rules. Because the program would be implemented gradually during the first five years, it is not until 1984 that the full benefit of the more liberal depreciation allowances would be given to investment for any one year. For this reason, the revenue costs continue to build until 1988, after which revenue losses begin to fall. Eventually, the level of these losses stabilizes and thereafter they grow at about the same rate as investment expenditures. By 1987, when corporate tax receipts are expected to be \$116.7 billion, S.1435 would provide corporate tax reduction of nearly half that amount. The total revenue cost also includes a reduction in individual income taxes resulting from deductions taken by unincorporated businesses. This is equal to about 15 percent of the total revenue cost.

The year-by-year revenue costs do not take account of the additional tax receipts resulting from economic expansion induced by the tax reductions. These "feedback" revenues amount to about 30 percent of the static revenue loss and are reflected primarily in increases in individual tax receipts. If these "feedback" revenues are taken into account, the result is a net revenue loss of about \$35 billion in 1984. It should be noted that the additional tax receipts that would be induced by this tax cut are about the same as that from any tax reduction having a comparable impact on GNP.

Background on Depreciation Allowances

The present tax depreciation system is cumbersome and complex. It involves a number of choices and uncertainties, and is especially burdensome for small businesses. It should be simplified. The present system provides an insufficient incentive for capital expansion in periods of rapid inflation and financial uncertainty. These incentives should be strengthened as much as our budget resources will allow.

Under the present rules, the business taxpayer is confronted with a myriad of choices. The first choice is whether to use the Asset Depreciation Range (ADR) System or to justify tax allowances on taxpayer's particular facts and circumstances. For those electing ADR, there is a choice of useful life within the allowable range for each class of assets. For all taxpayers there is also a choice of depreciation methods over the chosen lifetime. For some types of assets, especially buildings, there may be no ADR class and there may be a restricted choice of methods. With regard to types of equipment having allowable lives less than 7 years, the taxpayer must choose whether to forego some portion of the investment tax credit in favor of more rapid write-off. For large firms having computerized accounting systems, these options present no formidable problems. They elect ADR, using the most rapid method of depreciation, and the shortest available useful life after taking account of the investment credit rules. These large firms own the great bulk of depreciable assets.

A very small percentage of small business taxpayers have chosen to elect the ADR system. Despite recent changes in regulations to reduce requirements for reporting, small businesses apparently believe that ADR dictates a more complicated accounting system and involves more complex regulations. If these small businesses choose not to elect

ADR, but to use the shorter lives that are allowed without question to ADR electors--and we believe many small businesses so choose--they face the possibility that upon audit they may be required to justify those lives on facts and circumstances. For these reasons, small businesses may regard the ADR system as not addressed to their needs and circumstances.

Productivity and Investment

The stimulation of investment and improvement of productivity performance must be among the foremost objectives of economic policy. The share of business fixed investment in GNP has varied around a nearly flat trend for about the last 15 years (Chart 1). However, in the last expansion it neither grew as rapidly nor reached as high a peak as during the previous cycle that peaked in 1974. Investment in nonresidential structures has shown a persistent downward trend since 1966, while the equipment component has tended to increase as a percentage of GNP. This is partly explained by mandated expenditures for pollution control equipment, which are now about 7 percent of equipment spending.

Aggregate productivity growth has exhibited a pronounced decline in the last decade and output per hour worked is now well below its post-war trend (Chart 2). For the 20 years ending 1968, the annual rate of growth in output per hour worked was about 2 1/2 percent. More recently, and beginning even before the oil embargo and the recession of 1974 and 1975, the rate of this productivity growth has markedly slowed. In the years 1968 through 1973 the growth rate was only about 1 3/4 percent.

In the last recovery cycle, the upturn in productivity growth that normally accompanies expansion occurred later and was generally weaker than in other post-war recoveries (Chart 3). The average for this latest period, 1973-78 was an annual productivity gain of only one percent. This slowing of productivity growth has helped to perpetuate a spiral of inflationary wage price adjustments in the economy and has eroded our ability to compete in international markets.

While the recent growth in average productivity throughout the economy is unmistakably lower in recent years, this record is by no means uniform across major productive sectors (see Chart 4). The communications sector has experienced rapid and even accelerating growth in productivity throughout the period, while at the other

extreme, the construction industries have suffered declines in productivity in absolute terms since the late sixties, particularly over the most recent years. Among the public utilities, productivity growth has also slowed markedly since the late 1960s after rapid and steady increases up to that time. The record in manufacturing also shows a decline in the productivity growth throughout the 1970s but that growth has continued up to the present time, except for a one-year downturn in 1974. In the trade sector, output per hour has grown at less than a 2 percent annual rate over the entire period and is nearly flat in recent years.

Within the manufacturing sector, productivity growth has been and continues to be somewhat stronger in non-durables manufacturing as compared to the durables sector (see Chart 5). Among the durable goods industries the record of the motor vehicle industry has been particularly strong since 1974, while a pronounced decline in productivity has occurred in that some period for the primary metals industry.

The wide diversity in productivity gains across sectors and industries illustrates the importance of looking behind the aggregate trends. To the extent that declines in productivity in particular sectors can be attributed to lagging capital formation, we should pay close attention to the distribution of tax incentives among sectors of the economy, in addition to the aggregate amount of incentive. This is not to suggest that we attempt to direct all of the tax relief to particular industries that have poor productivity records (or those that have performed well) in the recent past but we should know the degree to which any proposal matches the incentives to the economic objectives.

Acceleration of depreciation allowances can be effective in providing investment stimulus. The direct tax savings that accompany the acquisition of capital provides additional cash flow to business firms for further investment and replacement. It is as if interest-free loans from the government were provided in the early years of a capital asset's use to be repaid out of the future productive output of these assets. These accelerated deductions reduce the "tax wedge" that is interposed between the returns to the physical investment and the rewards that can be paid to those who supply funds for investment. The reduction in the tax wedge reduces the cost of capital and, thereby, increases the amount of capital that can be profitably employed for the benefit of the company, its employees, and its customers.

The Concept of Capital Recovery

Before I get to a specific analysis of some of its likely consequences of the 10-5-3 proposal, I would like to discuss briefly the concept of capital recovery allowances. Many people regard depreciation as an arcane topic involving "useful lives," complicated formulas such as double declining balance and sum-of-years-digits, vintage accounting, and numerous other technicalities. Although the subject of depreciation is replete with imposing terminology, the underlying concept is straightforward. Depreciation is a cost of employing capital; as such, it must be deducted to arrive at net income, the same way that a wage deduction is taken for payments for labor.

In order to impose a tax on net income, the timing of receipts and expenses must be matched, and this requires that the cost of assets be deducted as they are consumed by use in a business. The Internal Revenue Code provides that there shall be a reasonable allowance for exhaustion, wear and tear, and obsolescence.

Of course, the determination of capital recovery allowances in any tax system is more difficult than for wage deductions because there is no current payment that measures the exact amount of capital consumed from one year to the next. The cost of depreciation each year is, therefore, estimated to be some proportion of the acquisition, or historical, cost of the asset. Inflation, however, increases capital consumption as measured in current dollars, and, therefore, depreciation allowances based on historical cost may be inadequate. Acceleration of tax depreciation may compensate for the general understatement of depreciation.

If the allowable depreciation deduction is greater for any year than the amount of capital consumed, the government is in effect extending an interest-free loan to the business. In the opposite case, inadequate depreciation allowance will prematurely increase taxable income, impose prepayment of taxes, and reduce internal cash flow.

The Effects of 10-5-3

The 10-5-3 proposal is a major departure from current practice in the determination of depreciation or capital recovery allowances. It would allow a large share of the acquisition cost of equipment and structures to be deducted for tax purposes much more rapidly than currently. The proposal deals with the problem of complexity by

substituting a single mandatory system in place of the existing complex of choices. The proposed system has simple categories, certain recovery periods, and a fully prescribed pattern of recovery allowances. This approach to both investment incentives and simplification deserves consideration, but there are deficiencies that should be examined carefully.

For example, the proposal is not as simple as it first appears. As drafted, the 10-5-3 proposal would have to establish mandatory guidelines lives during the five year phase-in that are tied to the ADR classification system. Each year, for five years, every taxpayer would apply a new schedule of depreciation rates to assets acquired in that year until they are fully written off. The phase-in rules also create a perverse incentive effect that postponement of investment until the following year will increase the rate of capital recovery allowances. The phase-in is intended to postpone the revenue losses, but it also increases complexity and uncertainty. To the extent that investment is delayed, feedback revenues are also delayed.

When the 10-5-3 rules are fully effective, their combination of rapid write-offs of and increased investment credit for machinery and equipment would be very generous, indeed. The investment credit would immediately pay for 10 percent of the cost of acquiring new equipment. Then 76 percent of the gross cost could be written off in the first three years; the entire amount in 5 years. The present value of the tax saving from the combination of the investment credit and the accelerated deductions is greater than full, first-year write-off would be. The treatment of equipment under 10-5-3 would be better for the taxpayer than immediate expensing.

Such a dramatic increase in capital allowance is not only expensive in terms of the budget, but it could also greatly increase tax shelter activity. The proposed deductions and credits would be most attractive to high-income individuals who could obtain the tax benefits through net leasing of machinery and equipment. Tax shelter opportunities could also increase for those investing in buildings, such as offices and shopping centers, as the proposed bill both shortens the recovery period for these buildings and accelerates the depreciation method. A tougher recapture rule for buildings is proposed in the bill, but this only offsets a portion of the potential tax-shelter benefits.

Another result of 10-5-3 is a wide range of differential benefits among businesses according to the types of assets that they use and their present industry classification. For example, machinery and equipment (other than automobiles and light trucks) are now depreciated as if they had an average depreciation lifetime of 10.2 years (Table 2); the recovery period prescribed in S. 1435 is less than half that current average. For buildings, present practice is equivalent to an average lifetime of 32.6 years. The proposal would allow these buildings to be written off in less than one-third that time. For autos and light trucks, the reduction is relatively small from 3.5 years to 3.0 years, although, in many cases, autos and trucks would benefit from an increase in the investment credit.

The variation in benefits provided by 10-5-3 is most pronounced when industry categories are compared. After the five year phase-in, all major industry classes would have higher depreciation allowances under 10-5-3. However, the share of projected total investment "paid for" by accelerated depreciation is generally higher for those industries employing longer-lived assets. For machinery and equipment, you can see (Table 2) that the reduction in the recovery period is minimal in the case of construction and very small for manufacture of motor vehicles. Toward the other end of the spectrum, the recovery period for assets used in the primary metals industry would be nearly half the present ADR lives, communications would be about one-third, and public utilities about one-fourth. (Table 3 attached to this statement provides quarter industry detail.)

The Treasury Department has simulated changes in depreciation periods, together with the changes in the investment credit, to estimate potential tax savings during the period of phase-in. These estimates are then used to compute the tax saving per dollar of projected investment. Not surprisingly, the relative magnitudes generally follow in the same order as the degree of reduction in write-off periods (Chart 6). In 1984, the tax saving per dollar of projected investment in the construction industry would be less than 5 percent; for motor vehicles it is 8 percent; for primary metals it is around 15 percent; for communications just less than 20 percent; and the tax saving would pay for more than 20 percent of investment in the public utilities.

You may wonder about the apparent revenue increase in motor vehicle manufacturing for 1981. This results from a phase-in rule that immediately increases the recovery period for the auto companies' special tools from three years up to five years. In later years, the year-by-year reduction prescribed for longer-lived assets becomes dominant.

Highway transportation, services, agriculture, wholesale and retail trade, fabricated metals, and electronics are among other industries with relatively smaller benefits (Table 4). Among the other larger gainers are railroads, shipping, and oil pipelines.

The benefits estimated here are "potential" in the sense that no allowance is made for the possibility that certain companies will have insufficient tax liabilities against which to take the full amount of any additional deduction. Likewise, the estimates for public utilities take no account of the rule that disallows the use of 10-5-3 to utilities that "flow through" the benefits of accelerated depreciation to consumers.

Among industries with relatively poor productivity performance over the last five years, the construction industry has the smallest amount of potential benefit from 10-5-3 among all industries and utilities has the largest (Chart 7). Looking at the stronger productivity sectors, communication is among the larger gainers from 10-5-3, while communications and motor vehicles are among the more modest beneficiaries. In general, there is no discernible relationship between the amount of additional capital formation incentive provided by 10-5-3 and the relative strength of productivity performance over the past five years. The point here is not that these should be exactly matched, but rather that it is very difficult to see any purpose to the vastly different amounts of investment incentive provided across industries by 10-5-3.

I do not come to you today with any specific proposal nor, in view of the deficiencies of 10-5-3, can I support S.1435. I am obviously concerned about the large revenue cost, and the implication that greatly differing amounts of investment stimulus would be scattered about indiscriminantly among industries and asset types.

The simplification objectives of 10-5-3 could be achieved through other depreciation proposals. I would further suggest that you should consider the continuation of some administrative mechanism for the system to assure that the capital recovery deductions allowed for tax purposes are consistent with changes in true depreciation costs. I believe we should analyze carefully a wide range of depreciation plans, and I will continue to develop and work with you to promote a depreciation or capital recovery system that we can all regard as simple, effective and fair. Such a system should be put into effect as soon as budgetary resources and prudent fiscal policy permit.

Table 1

Revenue Estimates
(\$Billions)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Change in Tax Liability - Calendar Years										
Corporate	-3.2	-8.5	-17.9	-29.9	-44.1	-57.2	-67.6	-72.9	-73.3	-70.9
Individual	-0.6	-1.5	-3.2	-5.3	-7.8	-10.1	-11.9	-12.9	-12.9	-12.5
Total	-3.8	-10.0	-21.1	-35.2	-51.9	-67.3	-79.5	-85.8	-86.2	-83.4
Change in Receipts - Fiscal Years										
Corporate	-1.5	-5.6	-12.7	-23.3	-36.2	-49.8	-61.7	-69.8	-73.0	-72.1
Individual	-0.2	-0.9	-2.1	-4.0	-6.2	-8.7	-10.8	-12.3	-12.9	-12.8
Total	-1.7	-6.5	-14.8	-27.3	-42.4	-58.5	-72.5	-82.1	-85.9	-84.9

Office of the Secretary of the Treasury
Office of Tax Analysis

October 19, 1979

Chart 1

BUSINESS FIXED INVESTMENT AS PERCENT OF REAL GNP

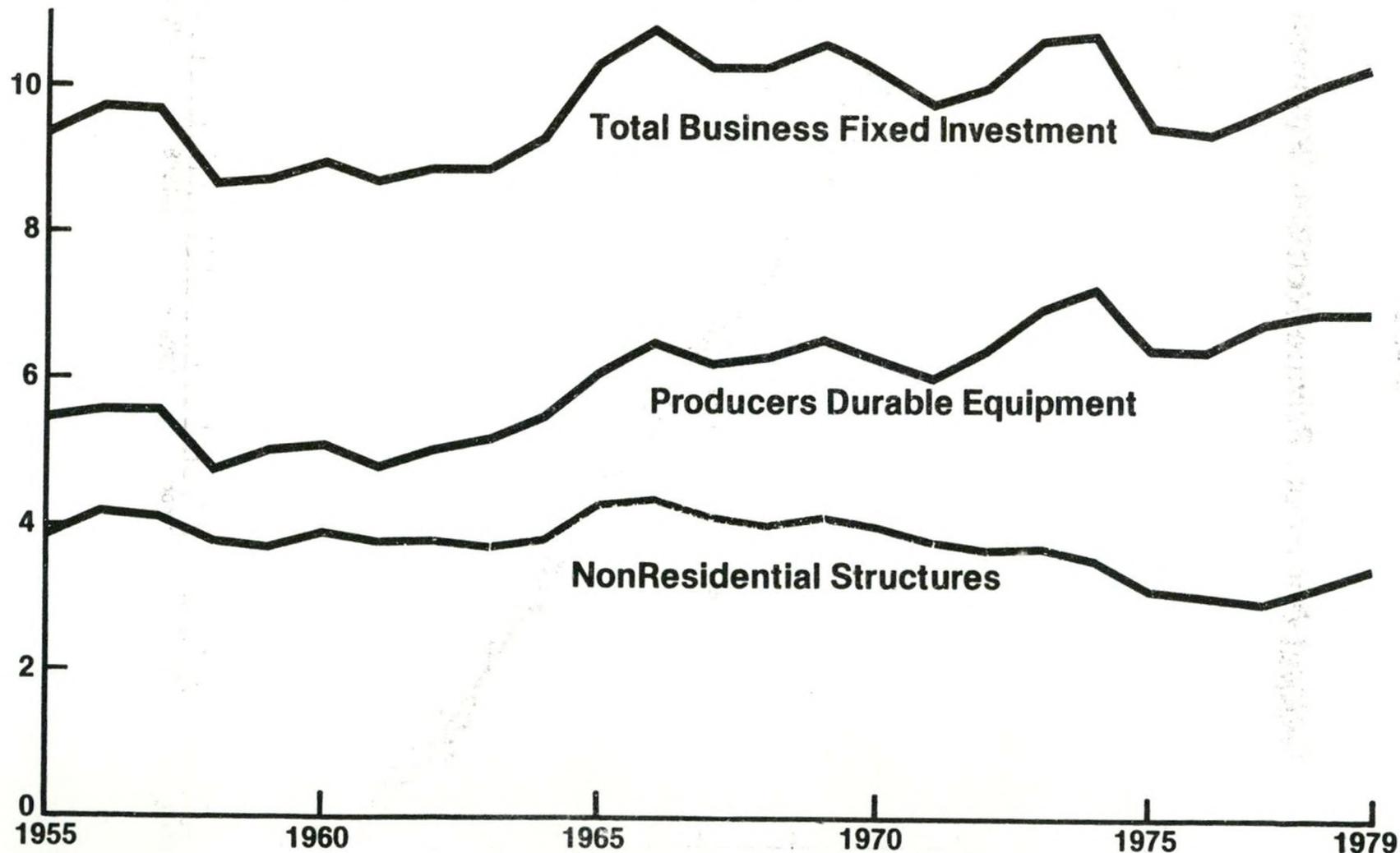
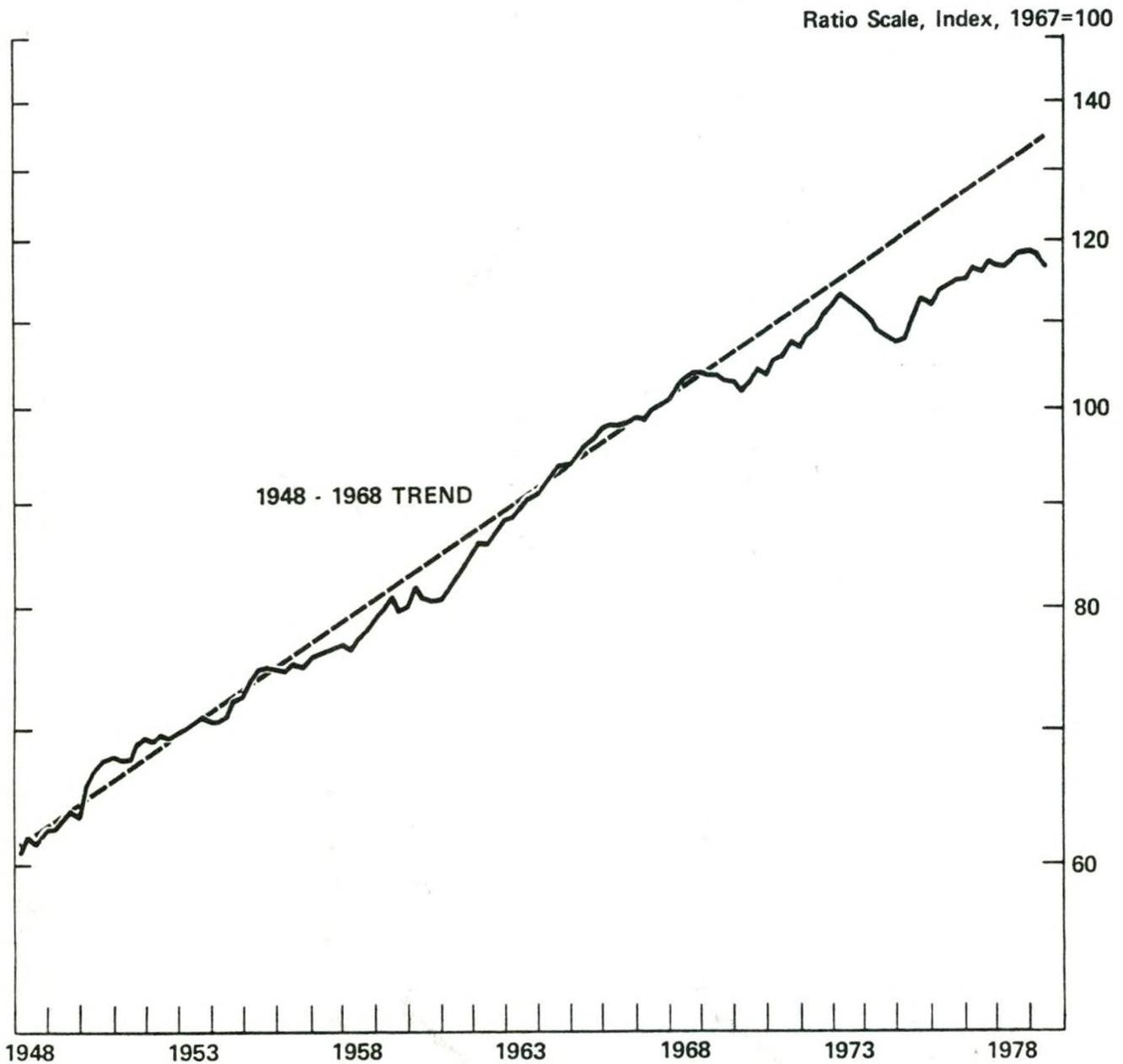
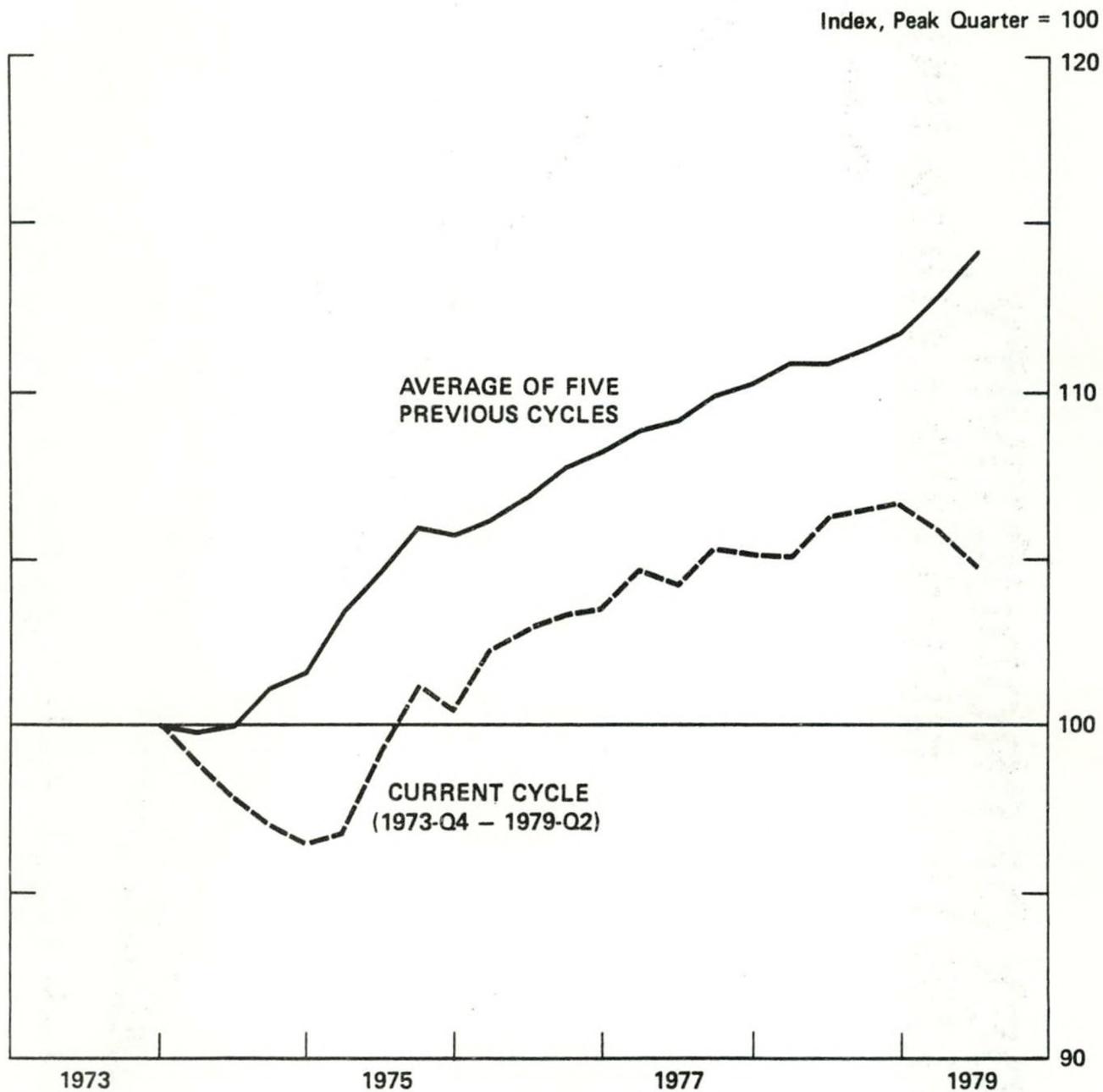


Chart 2

Output Per Hour, Private Nonfarm Business Sector

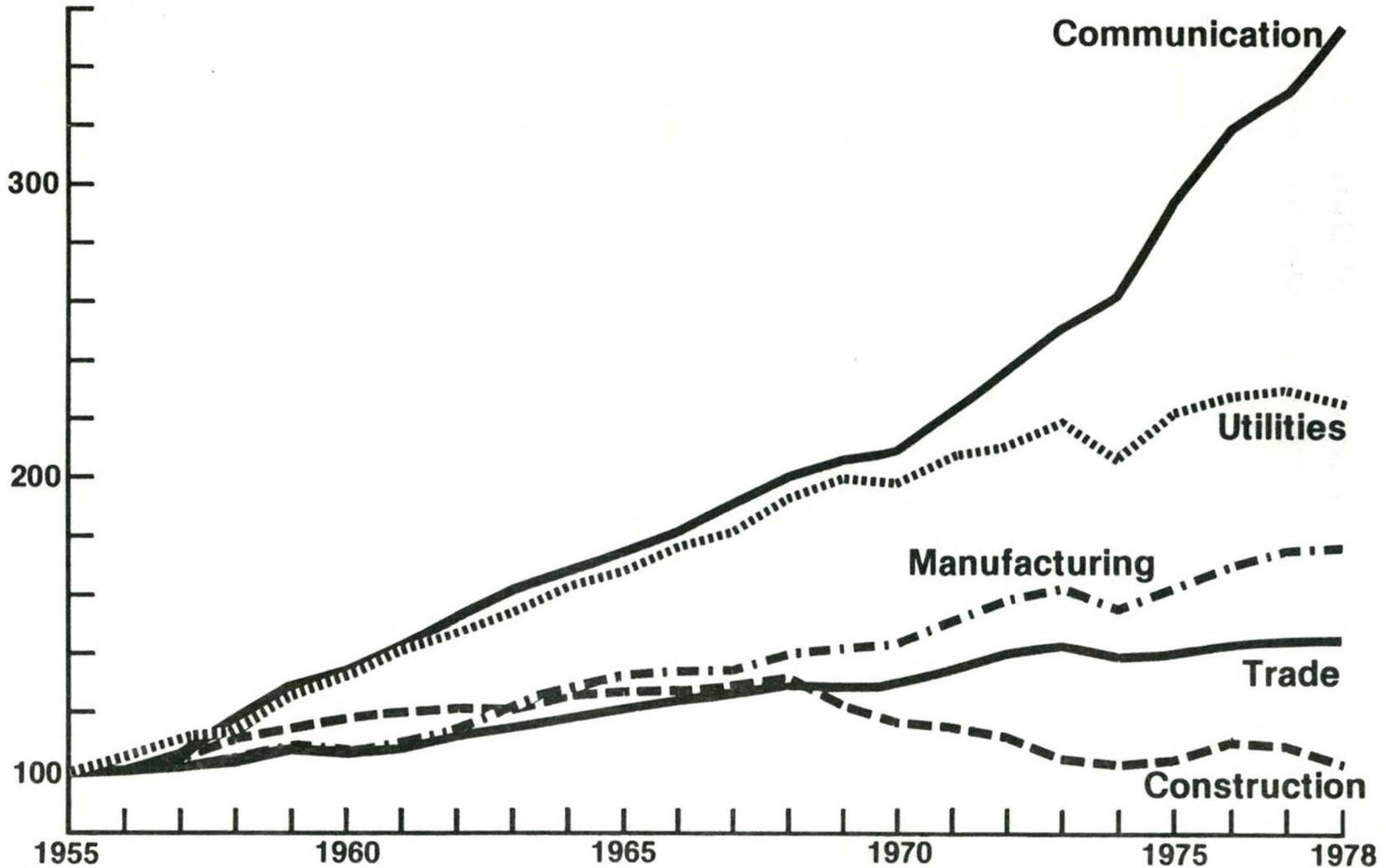


Cyclical Comparisons of Output Per Hour, Private Nonfarm Business Sector*



* Changes following the cyclical peaks as specified by NBER.

INDEX OF PRODUCTIVITY, SELECTED INDUSTRIES (1955=100)



INDEX OF PRODUCTIVITY, SELECTED MANUFACTURING INDUSTRIES (1955=100)

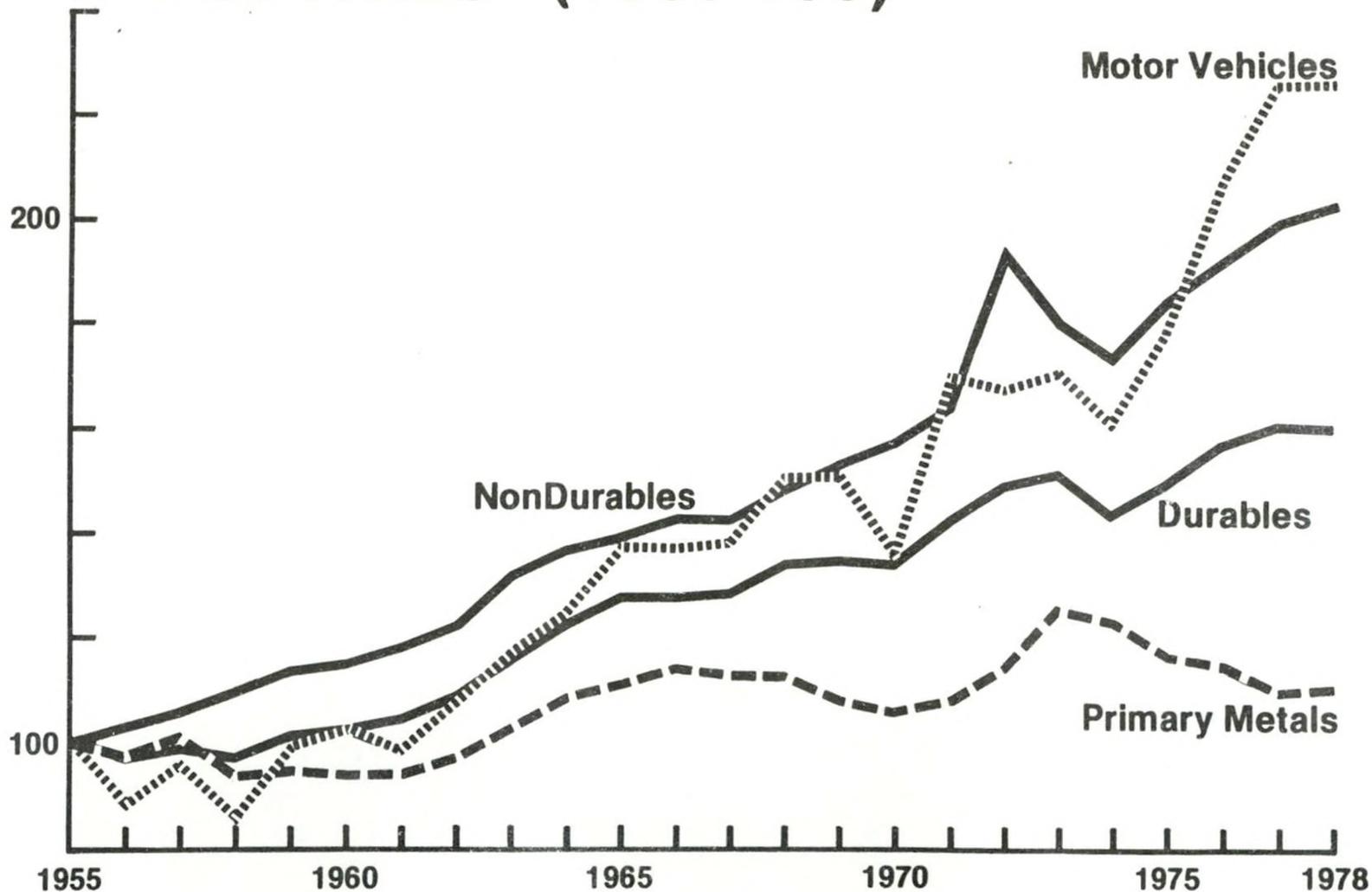


Table 2

“BEST ALLOWABLE” ADR DEPRECIATION PERIODS AS COMPARED TO 10-5-3 SELECTED INDUSTRIES

Asset Class	10-5-3		ADR				
	All Industries	All Industries	Construction	Motor Vehicles	Communication	Primary Metals	Utilities
Autos & Light Trucks	3	3.5	3.8	3.1	4.4	3.2	4.5
Other Machinery and Equipment	5	10.2	5.1	5.8	14.6	11.3	20.4
Buildings	10	32.6	35.0	35.0	36.0	35.0	35.0
Total	5.9	12.7					

Table 3

"Best Allowable" Depreciation Life (Years)
Under Present Law, by Industry

	Cars and Light Trucks	Machinery and Equipment	Building
All Industries	3.5	10.2	32.6
Agriculture	3.9	7.7	20.0
Construction	3.8	5.1	35.0
Oil and Gas			
Drilling	3.2	7.0	35.0
Production	3.2	11.0	35.0
Refining	3.4	12.4	35.0
Marketing	-	13.0	13.0
Mining	3.6	7.8	35.0
Manufacturing			
Food	3.2	9.2	35.0
Tobacco	3.3	11.4	35.0
Textiles	3.2	8.1	35.0
Apparel	3.1	7.1	35.0
Logging/Saw Mills	3.9	6.8	35.0
Wood Products	3.8	7.1	35.0
Pulp and Paper	3.2	9.9	35.0
Printing and publishing	3.1	8.7	35.0
Chemicals	3.1	7.7	35.0
Rubber Products	3.1	9.6	35.0
Plastic Products	3.0	8.0	35.0
Leather	3.0	8.5	35.0
Glass	3.0	9.2	35.0
Cement	3.5	14.0	35.0
Stone and Clay Products	3.5	10.9	35.0
Primary Metal	3.2	11.3	35.0
Fabricated Metal	3.1	4.9	35.0
Machinery	3.0	7.9	35.0
Electrical Machinery	3.0	9.3	35.0
Electronics	3.0	7.1	35.0
Motor Vehicles	3.1	5.8	35.0

"Best Allowable" Depreciation Life (Years)
Under Present Law, by Industry
(continued)

	Cars and Light Trucks	Machinery and Equipment	Buildings
Areospace	3.0	7.8	35.0
Shipbuilding	3.3	9.7	35.0
Railroad Equipment	3.3	8.8	35.0
Instruments	3.1	9.0	35.0
Other	3.1	9.0	35.0
Transportation			
Rail	-	11.7	-
Air	-	9.4	35.0
Water	-	15.7	35.0
Highway	3.4	5.6	35.0
Communication	4.4	14.6	36.0
Utilities			
Electric	4.5	20.5	35.0
Gas	4.5	23.1	35.0
Pipeline	-	17.5	35.0
Wholesale and Retail Trade	3.5	6.8	35.0
Services	3.3	7.8	35.0
Amusements	3.0	9.8	35.0

Note: The "best allowable" depreciation period for an industry is a special type of weighted average of the best available depreciation periods (taking account of the investment credit effects of lives lower than five or seven years) for equipment used in the industry. The weights are estimated 1976 investment in the several types of equipment. The weighted average takes account of the time value of tax saving. In the case of buildings not covered by ADR, the best available depreciation period is assumed to be 35 years, which is approximately the average useful life employed by taxpayers, as revealed by Treasury Department surveys in 1972 and 1973.

TAX SAVINGS DUE TO 10-5-3 PER DOLLAR OF PROJECTED INVESTMENT IN DEPRECIABLE ASSETS ; 1980, 1981, AND 1984, SELECTED INDUSTRIES

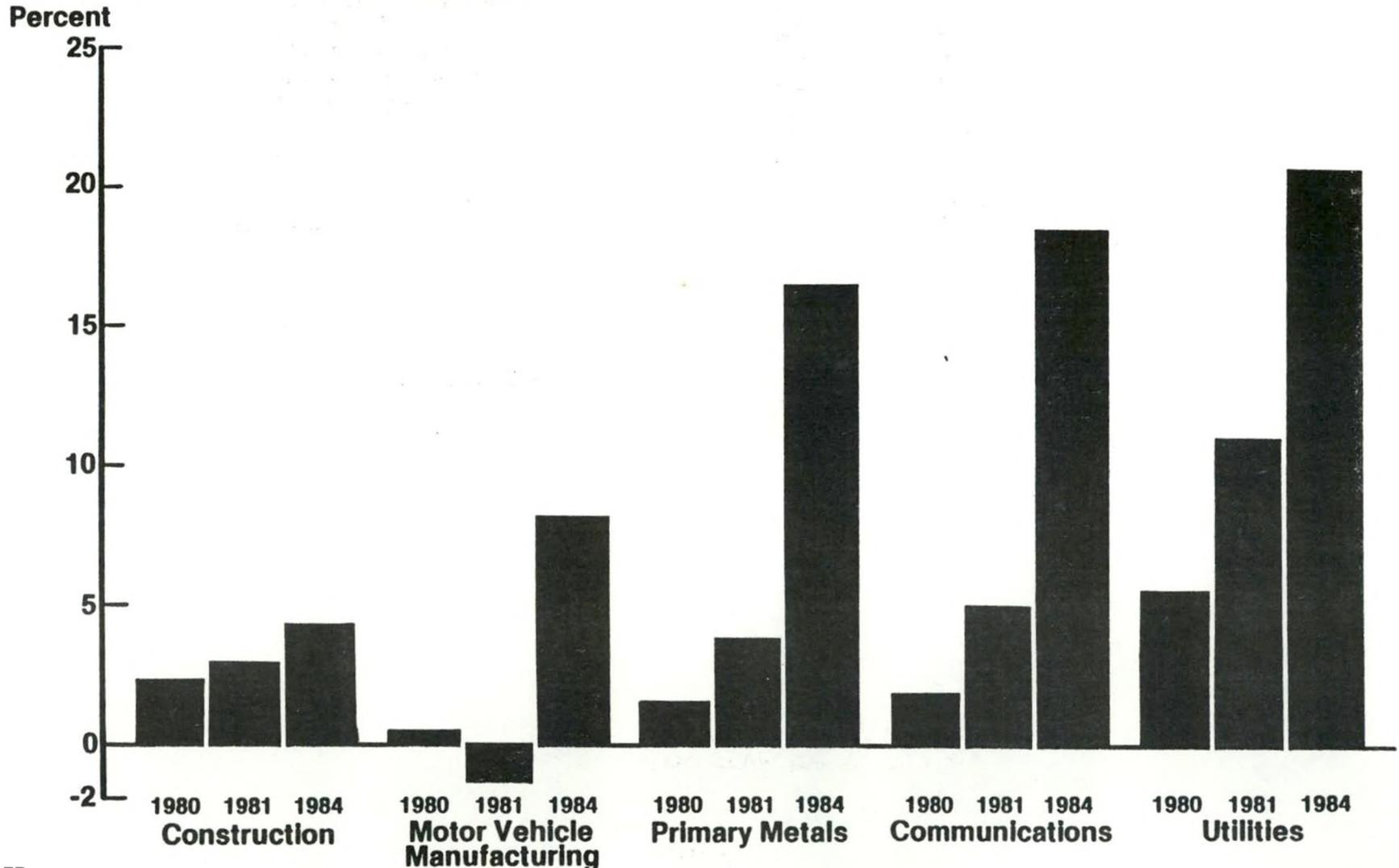


Table 4

Estimated Tax Reduction Due to 10-5-3
as a Percent of Projected Investment 1/, 1984

Industry Class	Estimated 1984 Tax Reduction (\$ Millions)	Projected 1984 Investment (\$ Millions)	1984 Tax Reduction As Percent of Investment
Manufacturing:			
Non-durables	5,729	50,016	11.5
Food	1,258	10,624	11.8
Tobacco	50	369	13.6
Textiles	332	2,757	12.0
Apparel	121	1,196	10.1
Pulp and Paper	837	7,777	10.8
Printing and Publishing	341	3,390	10.1
Chemicals	2,345	19,838	11.8
Rubber	123	927	13.3
Plastics	303	2,918	10.4
Leather	16	220	7.3
Durables			
Wood Products and Furniture	5,606	51,496	10.9
Cement	98	2,100	4.7
Glass	90	622	14.5
Other Stone and Clay	146	1,258	11.6
Ferrous Metals	281	2,150	13.1
Non-ferrous Metals	1,107	6,739	16.4
Fabricated Metals	421	3,004	14.0
Machinery	504	6,587	7.7
Machinery	950	8,345	11.4
Electrical Equipment	493	4,448	11.1
Electronics	266	2,884	9.2
Motor Vehicles	458	5,716	8.0
Aerospace	182	1,591	11.4

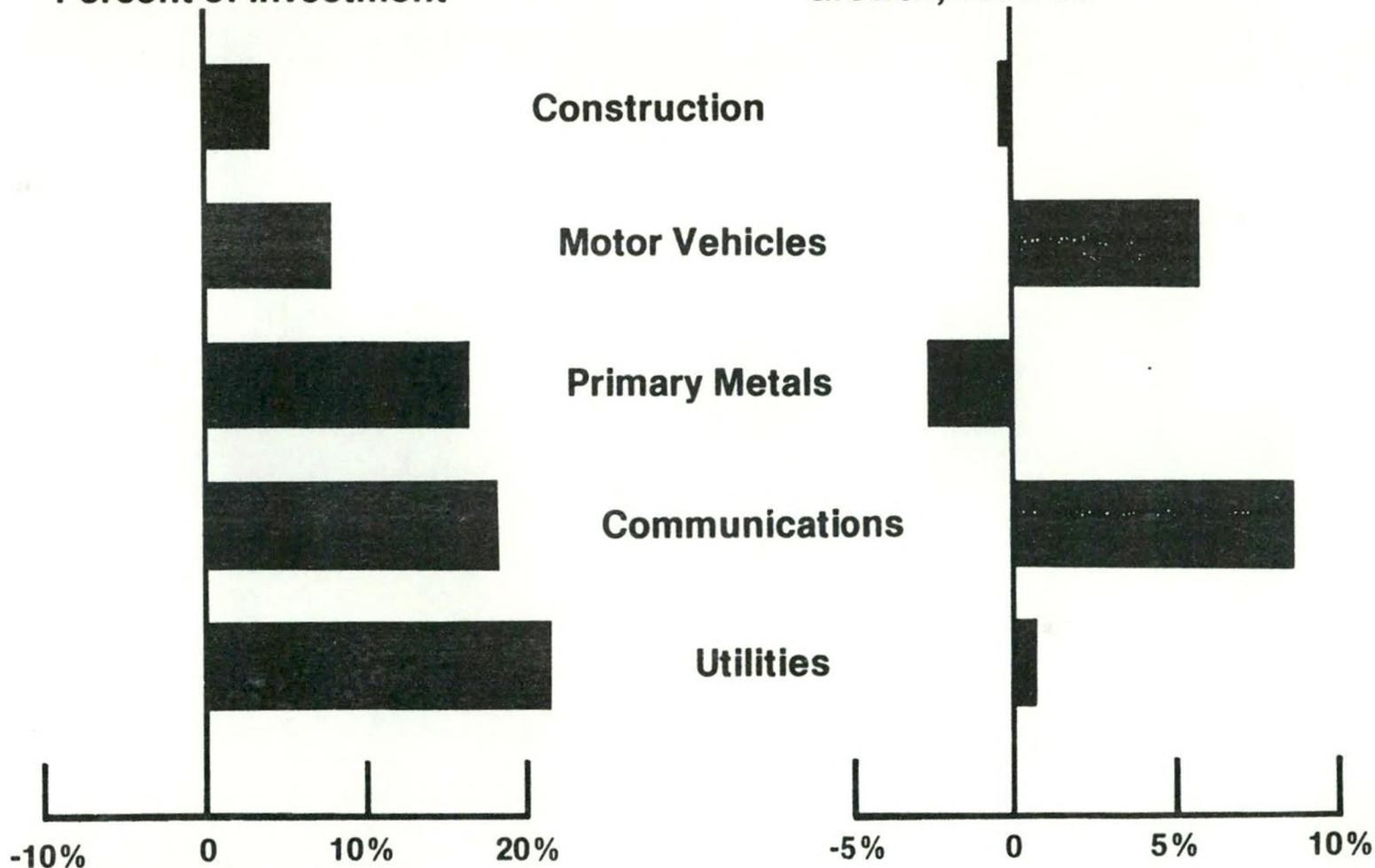
1/ Estimates of investment by purchasing sector are based on Annual Survey of Manufacturers, 1976, and data from regulatory agencies, trade associations, and other industry sources.

Industry Class	Estimated 1984 (\$Millions)	Projected 1984 (\$Millions)	1984 Tax Reduction As Percent of Investment
Shipbuilding	169	1,534	11.0
Railroad Equipment	17	129	13.2
Instruments	222	2,383	9.3
Other Manufacturing	202	2,006	10.1
Transportation	4,048	40,504	10.0
Railroads	562	3,362	16.7
Airlines	814	6,175	13.2
Water Transport	1,432	9,492	15.1
Highway Transport	1,240	21,475	5.8
Communication	5,956	32,130	18.5
Utilities	9,162	42,187	21.7
Electric Utilities	7,533	35,853	21.0
Gas Utilities and Pipelines	1,629	6,334	25.7
Mining, except oil and gas	1,120	10,796	10.4
Oil and Gas Drilling	238	2,945	8.1
Oil and Gas Production	5,079	38,390	13.2
Petroleum Refining	1,207	8,785	13.7
Petroleum Marketing	142	1,254	11.3
Oil Pipelines	2,202	10,175	21.6
Construction	1,114	25,085	4.4
Wholesale and Retail Trade	3,823	44,097	8.7
Agriculture	2,069	27,220	7.6
Services	3,337	41,109	8.1
Grand Total	51,912	435,725	11.9

BENEFITS OF 10-5-3 AS COMPARED TO RECENT GROWTH IN PRODUCTIVITY, SELECTED INDUSTRIES

1984 Tax Saving as
Percent of Investment

Average Annual Productivity
Growth, 1973-78





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I believe that a commitment to widen the budget deficit by the magnitude of S. 1435 would be premature at this time. However, we should study possibilities for a program that will promote longer-range economic objectives as effectively and fairly as possible. At the appropriate time, you should be prepared to act on a program carefully structured to expand economic capacity, to reduce production costs, and to promote productivity. Appropriate depreciation allowances can help to accomplish these goals and should be given serious consideration as an element of any future tax package.

Revenue Costs of 10-5-3

Looking specifically at the 10-5-3 proposal, I would first point out that it would have a massive budget impact. The cost of S.1435 rises from about \$4 billion in the first year to over \$50 billion in 1984 and over \$85 billion in 1988 (see Table 1).

These estimates have been carried out further into the future than we would normally show in order to see the full effect of the proposed phase-in rules. Because the program would be implemented gradually during the first five years, it is not until 1984 that the full benefit of the more liberal depreciation allowances would be given to investment for any one year. For this reason, the revenue costs continue to build until 1988, after which revenue losses begin to fall. Eventually, the level of these losses stabilizes and thereafter they grow at about the same rate as investment expenditures. By 1987, when corporate tax receipts are expected to be \$116.7 billion, S.1435 would provide corporate tax reduction of nearly half that amount. The total revenue cost also includes a reduction in individual income taxes resulting from deductions taken by unincorporated businesses. This is equal to about 15 percent of the total revenue cost.

The year-by-year revenue costs do not take account of the additional tax receipts resulting from economic expansion induced by the tax reductions. These "feedback" revenues amount to about 30 percent of the static revenue loss and are reflected primarily in increases in individual tax receipts. If these "feedback" revenues are taken into account, the result is a net revenue loss of about \$35 billion in 1984. It should be noted that the additional tax receipts that would be induced by this tax cut are about the same as that from any tax reduction having a comparable impact on GNP.

Background on Depreciation Allowances

The present tax depreciation system is cumbersome and complex. It involves a number of choices and uncertainties, and is especially burdensome for small businesses. It should be simplified. The present system provides an insufficient incentive for capital expansion in periods of rapid inflation and financial uncertainty. These incentives should be strengthened as much as our budget resources will allow.

Under the present rules, the business taxpayer is confronted with a myriad of choices. The first choice is whether to use the Asset Depreciation Range (ADR) System or to justify tax allowances on taxpayer's particular facts and circumstances. For those electing ADR, there is a choice of useful life within the allowable range for each class of assets. For all taxpayers there is also a choice of depreciation methods over the chosen lifetime. For some types of assets, especially buildings, there may be no ADR class and there may be a restricted choice of methods. With regard to types of equipment having allowable lives less than 7 years, the taxpayer must choose whether to forego some portion of the investment tax credit in favor of more rapid write-off. For large firms having computerized accounting systems, these options present no formidable problems. They elect ADR, using the most rapid method of depreciation, and the shortest available useful life after taking account of the investment credit rules. These large firms own the great bulk of depreciable assets.

A very small percentage of small business taxpayers have chosen to elect the ADR system. Despite recent changes in regulations to reduce requirements for reporting, small businesses apparently believe that ADR dictates a more complicated accounting system and involves more complex regulations. If these small businesses choose not to elect

ADR, but to use the shorter lives that are allowed without question to ADR electors--and we believe many small businesses so choose--they face the possibility that upon audit they may be required to justify those lives on facts and circumstances. For these reasons, small businesses may regard the ADR system as not addressed to their needs and circumstances.

Productivity and Investment

The stimulation of investment and improvement of productivity performance must be among the foremost objectives of economic policy. The share of business fixed investment in GNP has varied around a nearly flat trend for about the last 15 years (Chart 1). However, in the last expansion it neither grew as rapidly nor reached as high a peak as during the previous cycle that peaked in 1974. Investment in nonresidential structures has shown a persistent downward trend since 1966, while the equipment component has tended to increase as a percentage of GNP. This is partly explained by mandated expenditures for pollution control equipment, which are now about 7 percent of equipment spending.

Aggregate productivity growth has exhibited a pronounced decline in the last decade and output per hour worked is now well below its post-war trend (Chart 2). For the 20 years ending 1968, the annual rate of growth in output per hour worked was about 2 1/2 percent. More recently, and beginning even before the oil embargo and the recession of 1974 and 1975, the rate of this productivity growth has markedly slowed. In the years 1968 through 1973 the growth rate was only about 1 3/4 percent.

In the last recovery cycle, the upturn in productivity growth that normally accompanies expansion occurred later and was generally weaker than in other post-war recoveries (Chart 3). The average for this latest period, 1973-78 was an annual productivity gain of only one percent. This slowing of productivity growth has helped to perpetuate a spiral of inflationary wage price adjustments in the economy and has eroded our ability to compete in international markets.

While the recent growth in average productivity throughout the economy is unmistakably lower in recent years, this record is by no means uniform across major productive sectors (see Chart 4). The communications sector has experienced rapid and even accelerating growth in productivity throughout the period, while at the other

extreme, the construction industries have suffered declines in productivity in absolute terms since the late sixties, particularly over the most recent years. Among the public utilities, productivity growth has also slowed markedly since the late 1960s after rapid and steady increases up to that time. The record in manufacturing also shows a decline in the productivity growth throughout the 1970s but that growth has continued up to the present time, except for a one-year downturn in 1974. In the trade sector, output per hour has grown at less than a 2 percent annual rate over the entire period and is nearly flat in recent years.

Within the manufacturing sector, productivity growth has been and continues to be somewhat stronger in non-durables manufacturing as compared to the durables sector (see Chart 5). Among the durable goods industries the record of the motor vehicle industry has been particularly strong since 1974, while a pronounced decline in productivity has occurred in that same period for the primary metals industry.

The wide diversity in productivity gains across sectors and industries illustrates the importance of looking behind the aggregate trends. To the extent that declines in productivity in particular sectors can be attributed to lagging capital formation, we should pay close attention to the distribution of tax incentives among sectors of the economy, in addition to the aggregate amount of incentive. This is not to suggest that we attempt to direct all of the tax relief to particular industries that have poor productivity records (or those that have performed well) in the recent past but we should know the degree to which any proposal matches the incentives to the economic objectives.

Acceleration of depreciation allowances can be effective in providing investment stimulus. The direct tax savings that accompany the acquisition of capital provides additional cash flow to business firms for further investment and replacement. It is as if interest-free loans from the government were provided in the early years of a capital asset's use to be repaid out of the future productive output of these assets. These accelerated deductions reduce the "tax wedge" that is interposed between the returns to the physical investment and the rewards that can be paid to those who supply funds for investment. The reduction in the tax wedge reduces the cost of capital and, thereby, increases the amount of capital that can be profitably employed for the benefit of the company, its employees, and its customers.

The Concept of Capital Recovery

Before I get to a specific analysis of some of its likely consequences of the 10-5-3 proposal, I would like to discuss briefly the concept of capital recovery allowances. Many people regard depreciation as an arcane topic involving "useful lives," complicated formulas such as double declining balance and sum-of-years-digits, vintage accounting, and numerous other technicalities. Although the subject of depreciation is replete with imposing terminology, the underlying concept is straightforward. Depreciation is a cost of employing capital; as such, it must be deducted to arrive at net income, the same way that a wage deduction is taken for payments for labor.

In order to impose a tax on net income, the timing of receipts and expenses must be matched, and this requires that the cost of assets be deducted as they are consumed by use in a business. The Internal Revenue Code provides that there shall be a reasonable allowance for exhaustion, wear and tear, and obsolescence.

Of course, the determination of capital recovery allowances in any tax system is more difficult than for wage deductions because there is no current payment that measures the exact amount of capital consumed from one year to the next. The cost of depreciation each year is, therefore, estimated to be some proportion of the acquisition, or historical, cost of the asset. Inflation, however, increases capital consumption as measured in current dollars, and, therefore, depreciation allowances based on historical cost may be inadequate. Acceleration of tax depreciation may compensate for the general understatement of depreciation.

If the allowable depreciation deduction is greater for any year than the amount of capital consumed, the government is in effect extending an interest-free loan to the business. In the opposite case, inadequate depreciation allowance will prematurely increase taxable income, impose prepayment of taxes, and reduce internal cash flow.

The Effects of 10-5-3

The 10-5-3 proposal is a major departure from current practice in the determination of depreciation or capital recovery allowances. It would allow a large share of the acquisition cost of equipment and structures to be deducted for tax purposes much more rapidly than currently. The proposal deals with the problem of complexity by

substituting a single mandatory system in place of the existing complex of choices. The proposed system has simple categories, certain recovery periods, and a fully prescribed pattern of recovery allowances. This approach to both investment incentives and simplification deserves consideration, but there are deficiencies that should be examined carefully.

For example, the proposal is not as simple as it first appears. As drafted, the 10-5-3 proposal would have to establish mandatory guidelines lives during the five year phase-in that are tied to the ADR classification system. Each year, for five years, every taxpayer would apply a new schedule of depreciation rates to assets acquired in that year until they are fully written off. The phase-in rules also create a perverse incentive effect that postponement of investment until the following year will increase the rate of capital recovery allowances. The phase-in is intended to postpone the revenue losses, but it also increases complexity and uncertainty. To the extent that investment is delayed, feedback revenues are also delayed.

When the 10-5-3 rules are fully effective, their combination of rapid write-offs of and increased investment credit for machinery and equipment would be very generous, indeed. The investment credit would immediately pay for 10 percent of the cost of acquiring new equipment. Then 76 percent of the gross cost could be written off in the first three years; the entire amount in 5 years. The present value of the tax saving from the combination of the investment credit and the accelerated deductions is greater than full, first-year write-off would be. The treatment of equipment under 10-5-3 would be better for the taxpayer than immediate expensing.

Such a dramatic increase in capital allowance is not only expensive in terms of the budget, but it could also greatly increase tax shelter activity. The proposed deductions and credits would be most attractive to high-income individuals who could obtain the tax benefits through net leasing of machinery and equipment. Tax shelter opportunities could also increase for those investing in buildings, such as offices and shopping centers, as the proposed bill both shortens the recovery period for these buildings and accelerates the depreciation method. A tougher recapture rule for buildings is proposed in the bill, but this only offsets a portion of the potential tax-shelter benefits.

Another result of 10-5-3 is a wide range of differential benefits among businesses according to the types of assets that they use and their present industry classification. For example, machinery and equipment (other than automobiles and light trucks) are now depreciated as if they had an average depreciation lifetime of 10.2 years (Table 2); the recovery period prescribed in S. 1435 is less than half that current average. For buildings, present practice is equivalent to an average lifetime of 32.6 years. The proposal would allow these buildings to be written off in less than one-third that time. For autos and light trucks, the reduction is relatively small from 3.5 years to 3.0 years, although, in many cases, autos and trucks would benefit from an increase in the investment credit.

The variation in benefits provided by 10-5-3 is most pronounced when industry categories are compared. After the five year phase-in, all major industry classes would have higher depreciation allowances under 10-5-3. However, the share of projected total investment "paid for" by accelerated depreciation is generally higher for those industries employing longer-lived assets. For machinery and equipment, you can see (Table 2) that the reduction in the recovery period is minimal in the case of construction and very small for manufacture of motor vehicles. Toward the other end of the spectrum, the recovery period for assets used in the primary metals industry would be nearly half the present ADR lives, communications would be about one-third, and public utilities about one-fourth. (Table 3 attached to this statement provides quarter industry detail.)

The Treasury Department has simulated changes in depreciation periods, together with the changes in the investment credit, to estimate potential tax savings during the period of phase-in. These estimates are then used to compute the tax saving per dollar of projected investment. Not surprisingly, the relative magnitudes generally follow in the same order as the degree of reduction in write-off periods (Chart 6). In 1984, the tax saving per dollar of projected investment in the construction industry would be less than 5 percent; for motor vehicles it is 8 percent; for primary metals it is around 15 percent; for communications just less than 20 percent; and the tax saving would pay for more than 20 percent of investment in the public utilities.

You may wonder about the apparent revenue increase in motor vehicle manufacturing for 1981. This results from a phase-in rule that immediately increases the recovery period for the auto companies' special tools from three years up to five years. In later years, the year-by-year reduction prescribed for longer-lived assets becomes dominant.

Highway transportation, services, agriculture, wholesale and retail trade, fabricated metals, and electronics are among other industries with relatively smaller benefits (Table 4). Among the other larger gainers are railroads, shipping, and oil pipelines.

The benefits estimated here are "potential" in the sense that no allowance is made for the possibility that certain companies will have insufficient tax liabilities against which to take the full amount of any additional deduction. Likewise, the estimates for public utilities take no account of the rule that disallows the use of 10-5-3 to utilities that "flow through" the benefits of accelerated depreciation to consumers.

Among industries with relatively poor productivity performance over the last five years, the construction industry has the smallest amount of potential benefit from 10-5-3 among all industries and utilities has the largest (Chart 7). Looking at the stronger productivity sectors, communication is among the larger gainers from 10-5-3, while communications and motor vehicles are among the more modest beneficiaries. In general, there is no discernible relationship between the amount of additional capital formation incentive provided by 10-5-3 and the relative strength of productivity performance over the past five years. The point here is not that these should be exactly matched, but rather that it is very difficult to see any purpose to the vastly different amounts of investment incentive provided across industries by 10-5-3.

I do not come to you today with any specific proposal nor, in view of the deficiencies of 10-5-3, can I support S.1435. I am obviously concerned about the large revenue cost, and the implication that greatly differing amounts of investment stimulus would be scattered about indiscriminantly among industries and asset types.

The simplification objectives of 10-5-3 could be achieved through other depreciation proposals. I would further suggest that you should consider the continuation of some administrative mechanism for the system to assure that the capital recovery deductions allowed for tax purposes are consistent with changes in true depreciation costs. I believe we should analyze carefully a wide range of depreciation plans, and I will continue to develop and work with you to promote a depreciation or capital recovery system that we can all regard as simple, effective and fair. Such a system should be put into effect as soon as budgetary resources and prudent fiscal policy permit.

Table 1

Revenue Estimates
(\$Billions)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Change in Tax Liability - Calendar Years										
Corporate	-3.2	-8.5	-17.9	-29.9	-44.1	-57.2	-67.6	-72.9	-73.3	-70.9
Individual	-0.6	-1.5	-3.2	-5.3	-7.8	-10.1	-11.9	-12.9	-12.9	-12.5
Total	-3.8	-10.0	-21.1	-35.2	-51.9	-67.3	-79.5	-85.8	-86.2	-83.4
Change in Receipts - Fiscal Years										
Corporate	-1.5	-5.6	-12.7	-23.3	-36.2	-49.8	-61.7	-69.8	-73.0	-72.1
Individual	-0.2	-0.9	-2.1	-4.0	-6.2	-8.7	-10.8	-12.3	-12.9	-12.8
Total	-1.7	-6.5	-14.8	-27.3	-42.4	-58.5	-72.5	-82.1	-85.9	-84.9

Office of the Secretary of the Treasury
Office of Tax Analysis

October 19, 1979

Chart 1

BUSINESS FIXED INVESTMENT AS PERCENT OF REAL GNP

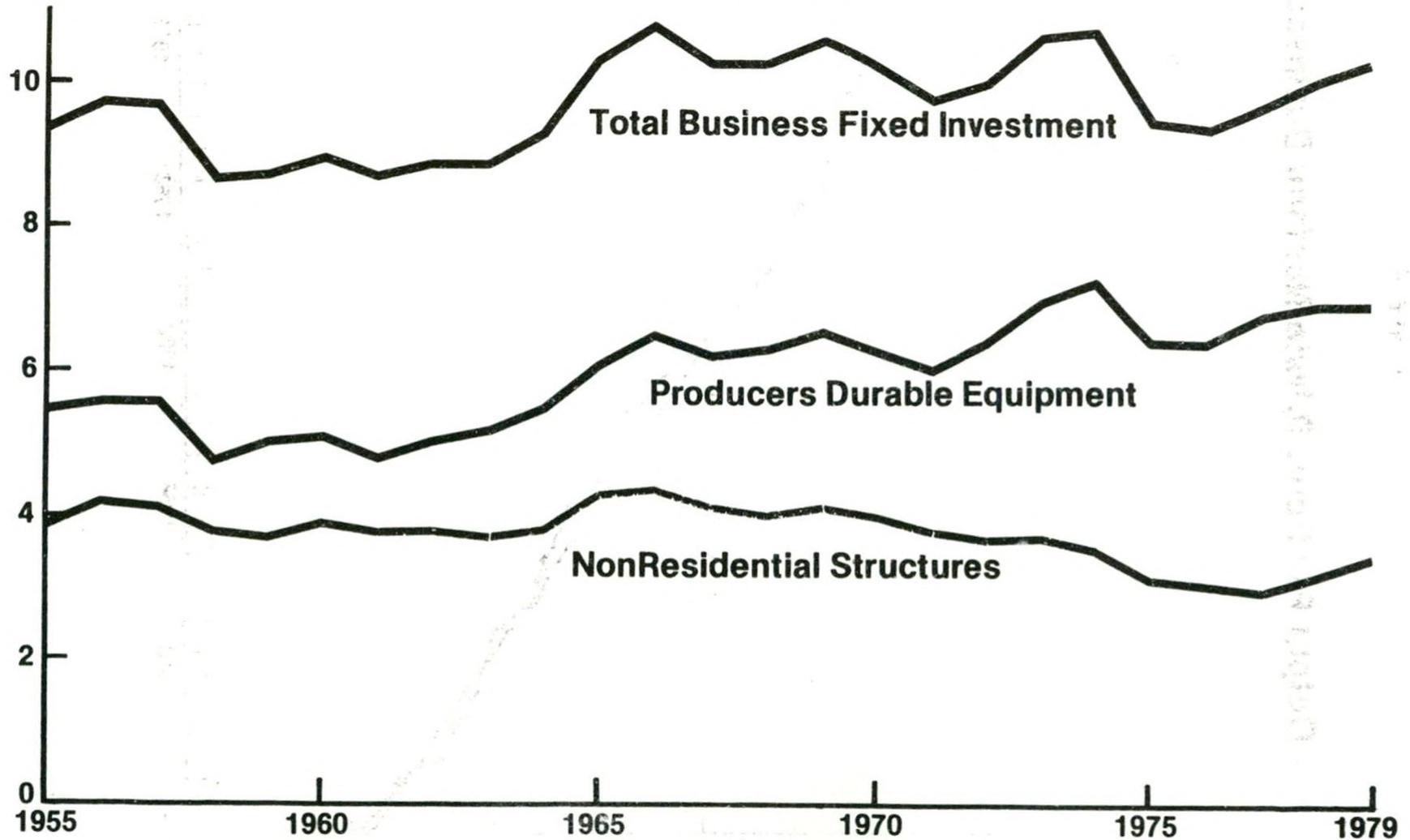


Chart 2

Output Per Hour, Private Nonfarm Business Sector

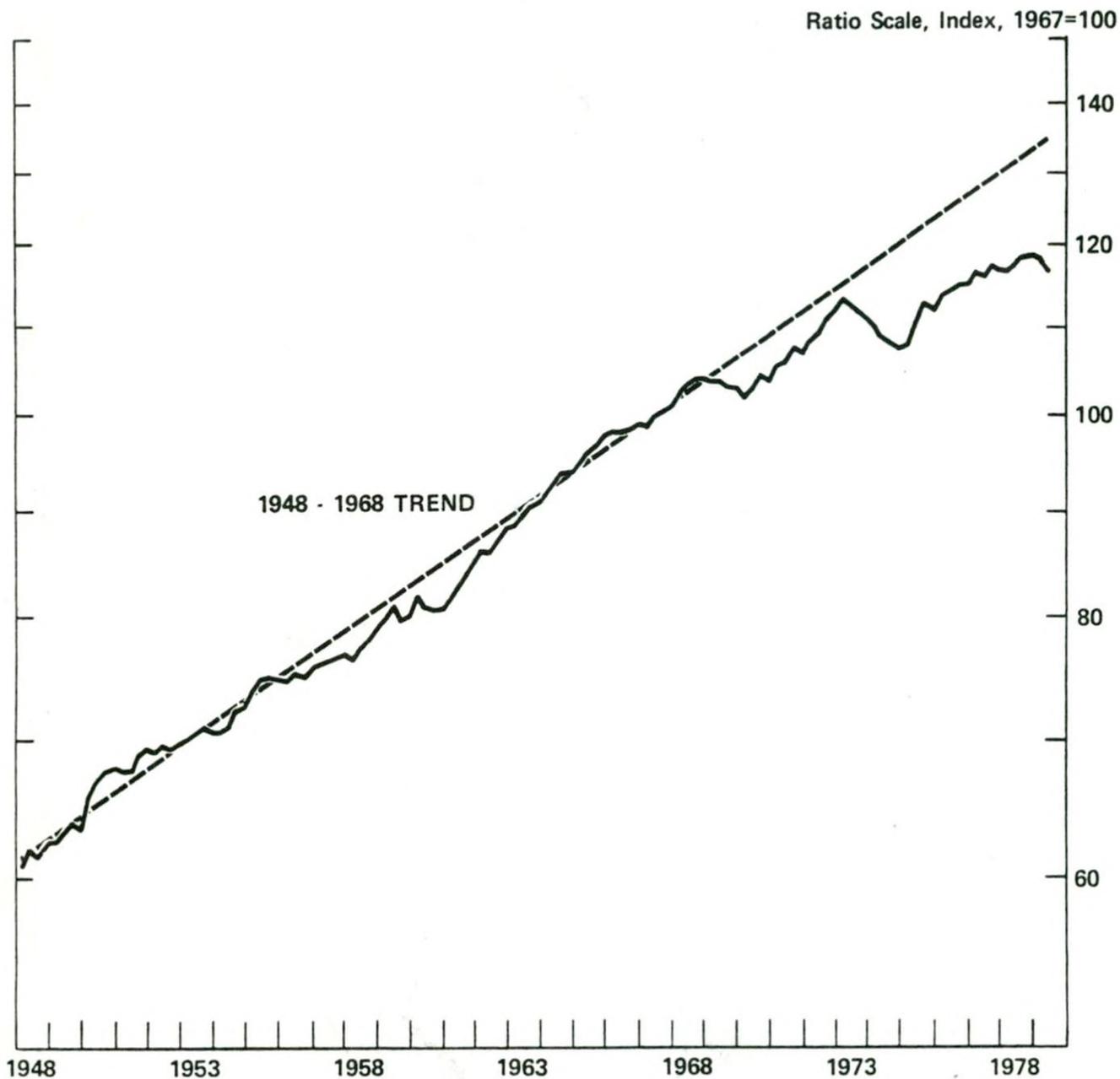
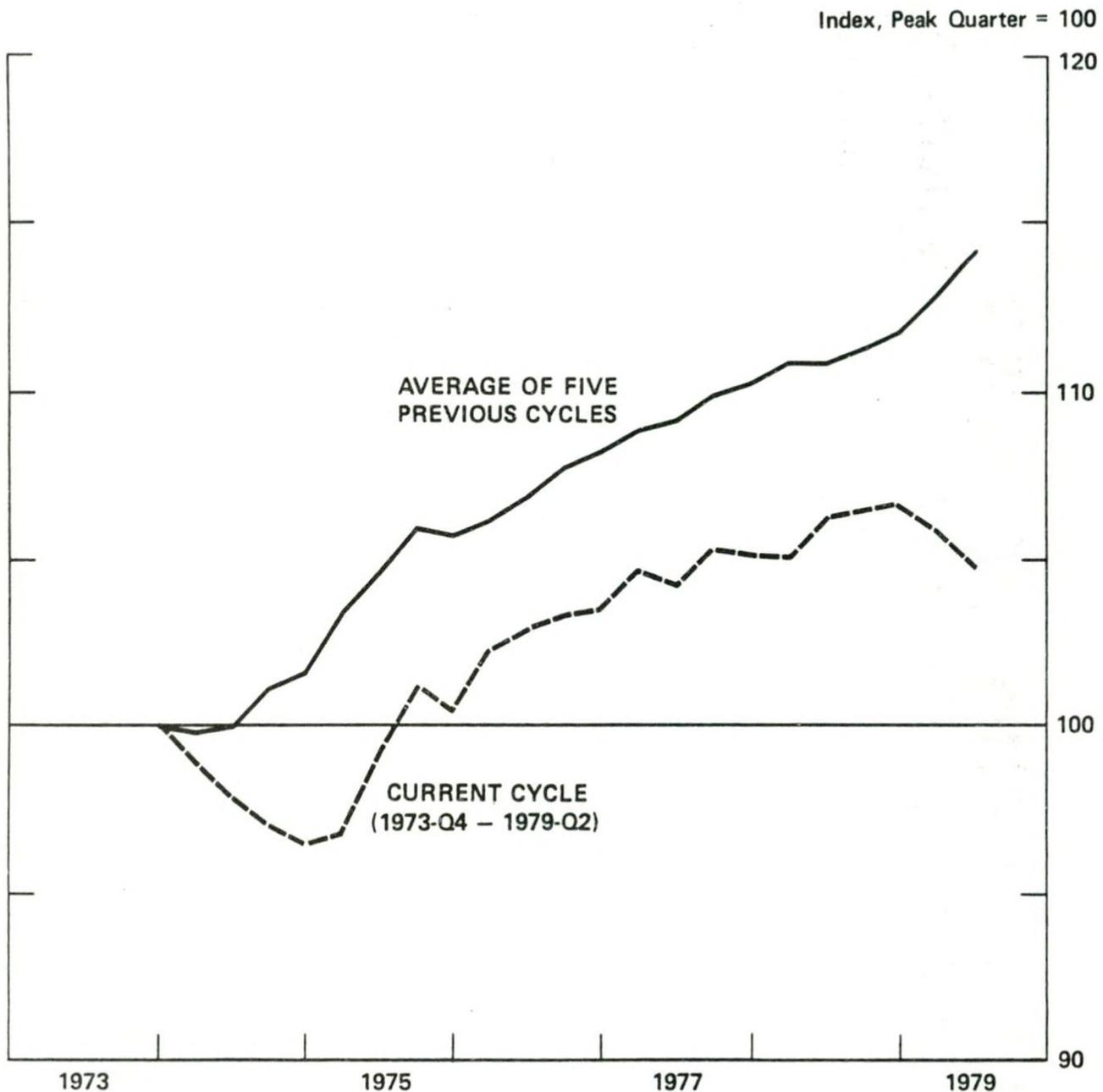


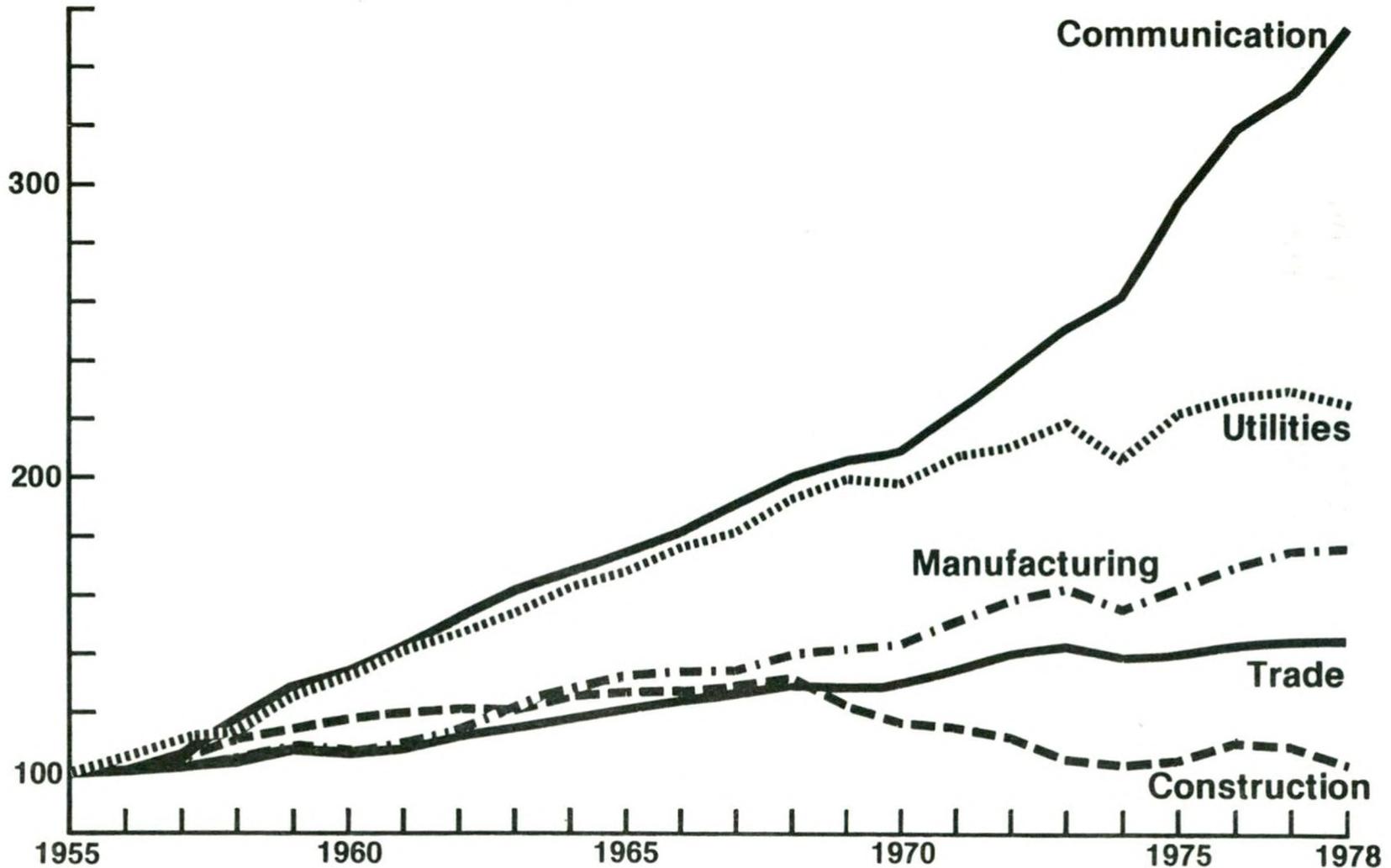
Chart 3

Cyclical Comparisons of Output Per Hour, Private Nonfarm Business Sector*



* Changes following the cyclical peaks as specified by NBER.

INDEX OF PRODUCTIVITY, SELECTED INDUSTRIES (1955=100)



INDEX OF PRODUCTIVITY, SELECTED MANUFACTURING INDUSTRIES (1955=100)

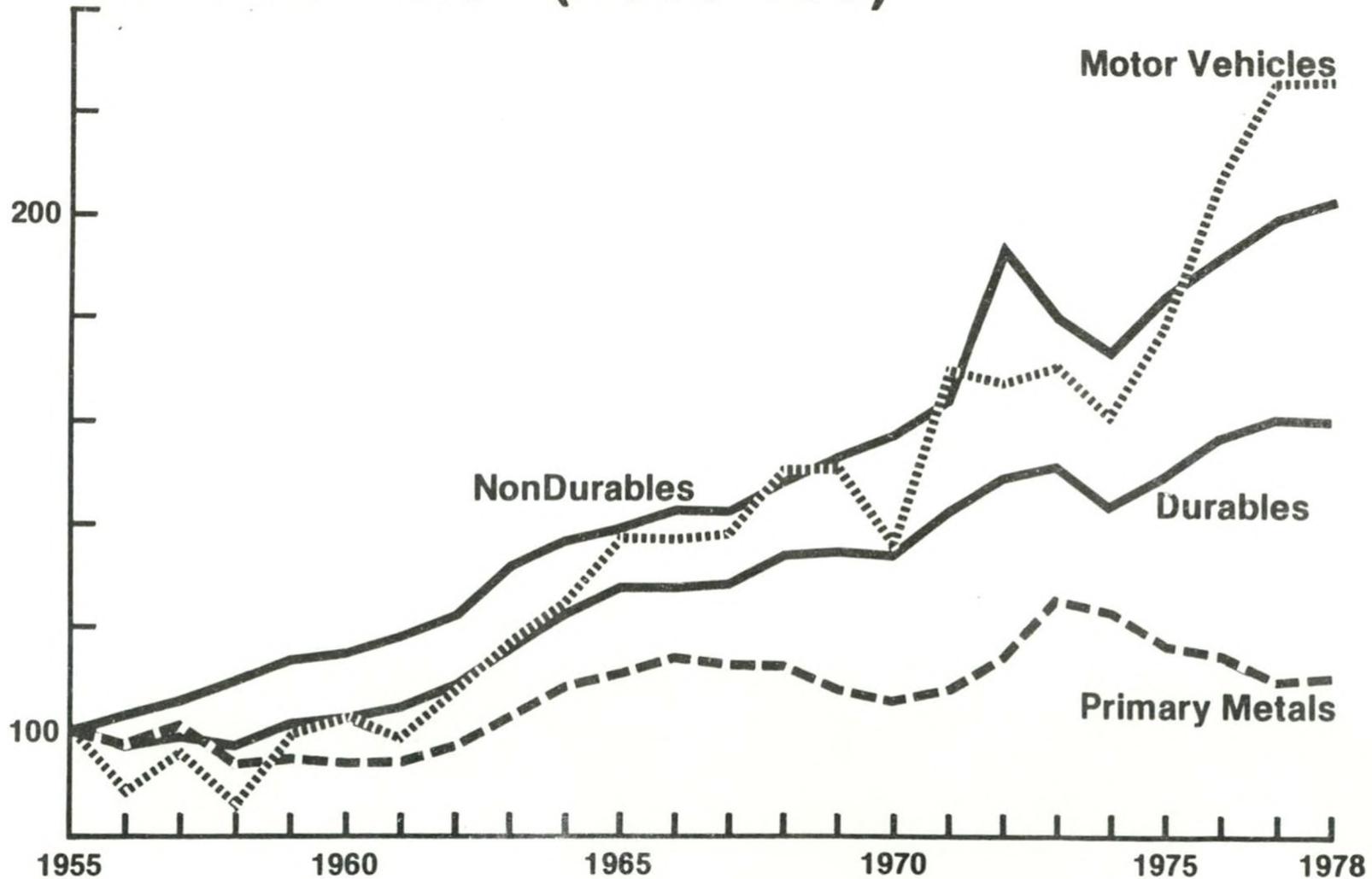


Table 2

“BEST ALLOWABLE” ADR DEPRECIATION PERIODS AS COMPARED TO 10-5-3 SELECTED INDUSTRIES

Asset Class	10-5-3		ADR				
	All Industries	All Industries	Construction	Motor Vehicles	Communication	Primary Metals	Utilities
Autos & Light Trucks	3	3.5	3.8	3.1	4.4	3.2	4.5
Other Machinery and Equipment	5	10.2	5.1	5.8	14.6	11.3	20.4
Buildings	10	32.6	35.0	35.0	36.0	35.0	35.0
Total	5.9	12.7					

Table 3

"Best Allowable" Depreciation Life (Years)
Under Present Law, by Industry

	Cars and Light Trucks	Machinery and Equipment	Building
All Industries	3.5	10.2	32.6
Agriculture	3.9	7.7	20.0
Construction	3.8	5.1	35.0
Oil and Gas			
Drilling	3.2	7.0	35.0
Production	3.2	11.0	35.0
Refining	3.4	12.4	35.0
Marketing	-	13.0	13.0
Mining	3.6	7.8	35.0
Manufacturing			
Food	3.2	9.2	35.0
Tobacco	3.3	11.4	35.0
Textiles	3.2	8.1	35.0
Apparel	3.1	7.1	35.0
Logging/Saw Mills	3.9	6.8	35.0
Wood Products	3.8	7.1	35.0
Pulp and Paper	3.2	9.9	35.0
Printing and publishing	3.1	8.7	35.0
Chemicals	3.1	7.7	35.0
Rubber Products	3.1	9.6	35.0
Plastic Products	3.0	8.0	35.0
Leather	3.0	8.5	35.0
Glass	3.0	9.2	35.0
Cement	3.5	14.0	35.0
Stone and Clay Products	3.5	10.9	35.0
Primary Metal	3.2	11.3	35.0
Fabricated Metal	3.1	4.9	35.0
Machinery	3.0	7.9	35.0
Electrical Machinery	3.0	9.3	35.0
Electronics	3.0	7.1	35.0
Motor Vehicles	3.1	5.8	35.0

"Best Allowable" Depreciation Life (Years)
Under Present Law, by Industry
(continued)

	Cars and Light Trucks	Machinery and Equipment	Buildings
Areospace	3.0	7.8	35.0
Shipbuilding	3.3	9.7	35.0
Railroad Equipment	3.3	8.8	35.0
Instruments	3.1	9.0	35.0
Other	3.1	9.0	35.0
Transportation			
Rail	-	11.7	-
Air	-	9.4	35.0
Water	-	15.7	35.0
Highway	3.4	5.6	35.0
Communication	4.4	14.6	36.0
Utilities			
Electric	4.5	20.5	35.0
Gas	4.5	23.1	35.0
Pipeline	-	17.5	35.0
Wholesale and Retail Trade	3.5	6.8	35.0
Services	3.3	7.8	35.0
Amusements	3.0	9.8	35.0

Note: The "best allowable" depreciation period for an industry is a special type of weighted average of the best available depreciation periods (taking account of the investment credit effects of lives lower than five or seven years) for equipment used in the industry. The weights are estimated 1976 investment in the several types of equipment. The weighted average takes account of the time value of tax saving. In the case of buildings not covered by ADR, the best available depreciation period is assumed to be 35 years, which is approximately the average useful life employed by taxpayers, as revealed by Treasury Department surveys in 1972 and 1973.

TAX SAVINGS DUE TO 10-5-3 PER DOLLAR OF PROJECTED INVESTMENT IN DEPRECIABLE ASSETS ; 1980, 1981, AND 1984, SELECTED INDUSTRIES

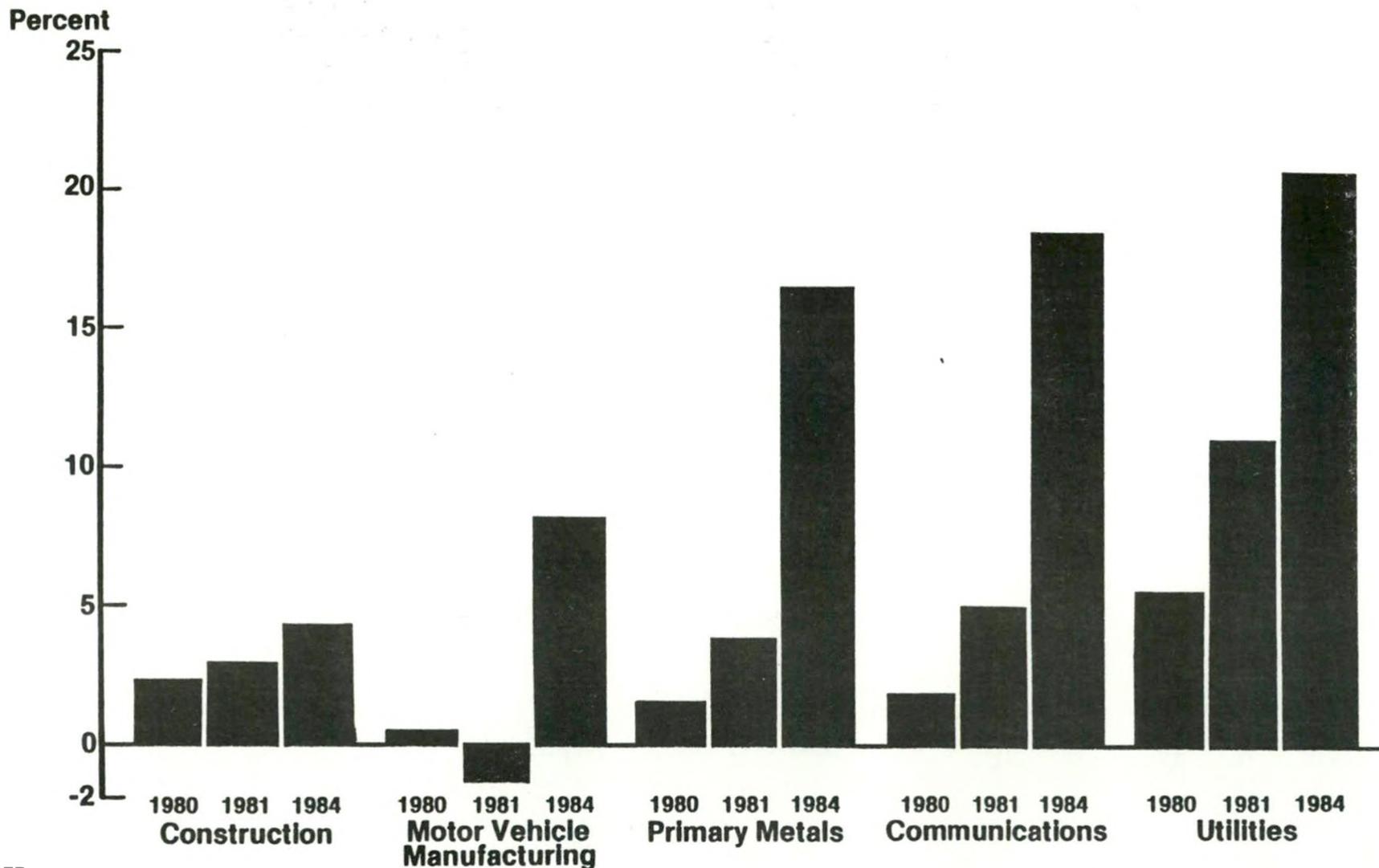


Table 4

Estimated Tax Reduction Due to 10-5-3
as a Percent of Projected Investment ^{1/}, 1984

Industry Class	Estimated 1984 Tax Reduction (\$ Millions)	Projected 1984 Investment (\$ Millions)	1984 Tax Reduction As Percent of Investment
Manufacturing:			
Non-durables	5,729	50,016	11.5
Food	1,258	10,624	11.8
Tobacco	50	369	13.6
Textiles	332	2,757	12.0
Apparel	121	1,196	10.1
Pulp and Paper	837	7,777	10.8
Printing and Publishing	341	3,390	10.1
Chemicals	2,345	19,838	11.8
Rubber	123	927	13.3
Plastics	303	2,918	10.4
Leather	16	220	7.3
Durables			
Wood Products and Furniture	5,606	51,496	10.9
Cement	98	2,100	4.7
Glass	90	622	14.5
Other Stone and Clay	146	1,258	11.6
Ferrous Metals	281	2,150	13.1
Non-ferrous Metals	1,107	6,739	16.4
Fabricated Metals	421	3,004	14.0
Machinery	504	6,587	7.7
Electrical Equipment	950	8,345	11.4
Electronics	493	4,448	11.1
Motor Vehicles	266	2,884	9.2
Aerospace	458	5,716	8.0
	182	1,591	11.4

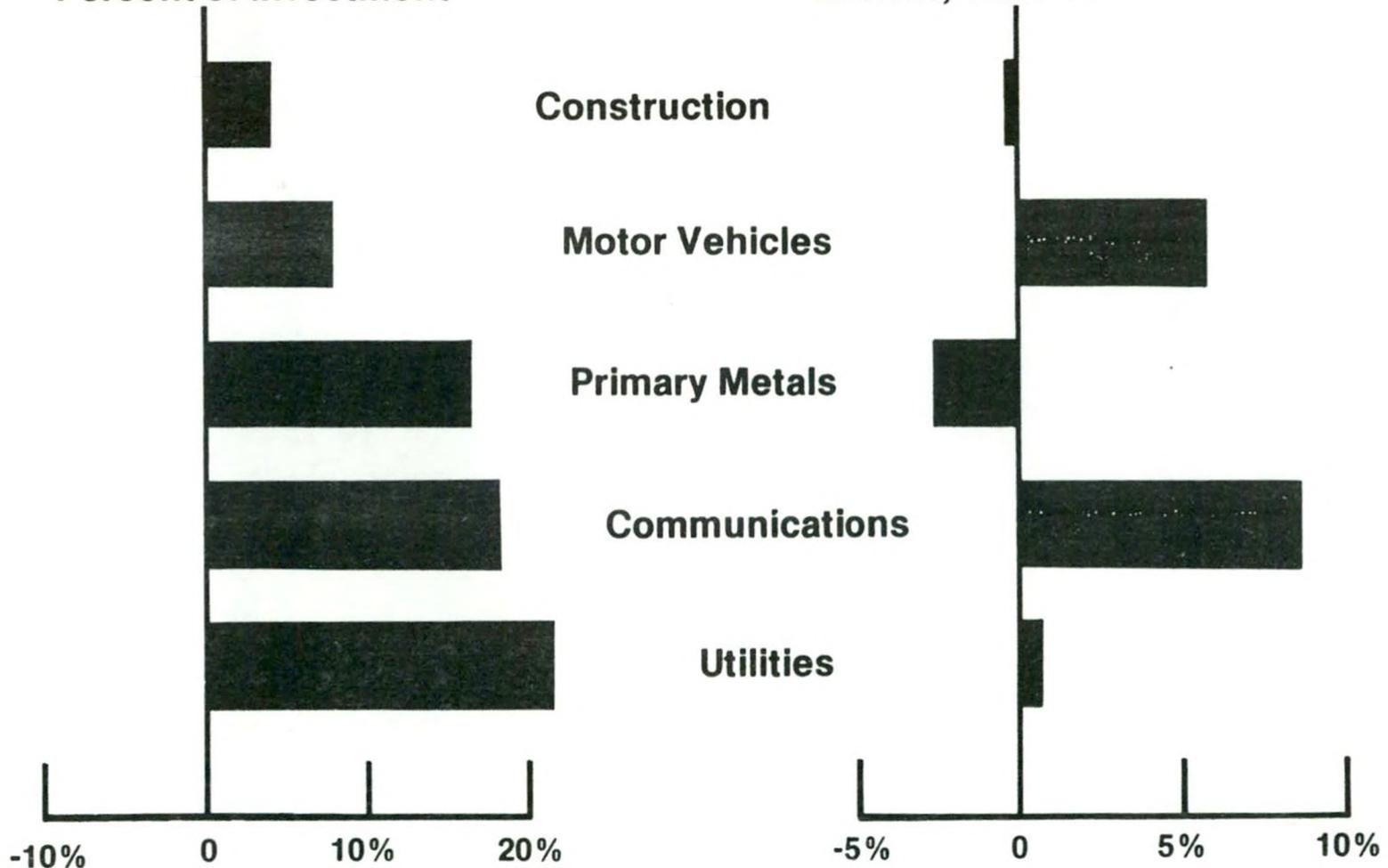
^{1/} Estimates of investment by purchasing sector are based on Annual Survey of Manufacturers, 1976, and data from regulatory agencies, trade associations, and other industry sources.

Industry Class	Estimated 1984 (\$Millions)	Projected 1984 (\$Millions)	1984 Tax Reduction As Percent of Investment
Shipbuilding	169	1,534	11.0
Railroad Equipment	17	129	13.2
Instruments	222	2,383	9.3
Other Manufacturing	202	2,006	10.1
Transportation	4,048	40,504	10.0
Railroads	562	3,362	16.7
Airlines	814	6,175	13.2
Water Transport	1,432	9,492	15.1
Highway Transport	1,240	21,475	5.8
Communication	5,956	32,130	18.5
Utilities	9,162	42,187	21.7
Electric Utilities	7,533	35,853	21.0
Gas Utilities and Pipelines	1,629	6,334	25.7
Mining, except oil and gas	1,120	10,796	10.4
Oil and Gas Drilling	238	2,945	8.1
Oil and Gas Production	5,079	38,390	13.2
Petroleum Refining	1,207	8,785	13.7
Petroleum Marketing	142	1,254	11.3
Oil Pipelines	2,202	10,175	21.6
Construction	1,114	25,085	4.4
Wholesale and Retail Trade	3,823	44,097	8.7
Agriculture	2,069	27,220	7.6
Services	3,337	41,109	8.1
Grand Total	51,912	435,725	11.9

BENEFITS OF 10-5-3 AS COMPARED TO RECENT GROWTH IN PRODUCTIVITY, SELECTED INDUSTRIES

1984 Tax Saving as
Percent of Investment

Average Annual Productivity
Growth, 1973-78





FOR RELEASE UPON DELIVERY
October 22, 1979 10:00 AM EDST

TESTIMONY OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY

BEFORE THE SUBCOMMITTEE OF TAXATION
AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

Thank you for inviting me to discuss S. 1435, a very significant proposal to restructure the system of depreciation allowances. I am pleased to see the broad interest in legislation to encourage capital formation and increase productivity.

The 10-5-3 proposal would restructure the system of tax allowances for capital recovery. It would greatly shorten the periods over which most capital expenditures can be written off. The proposal provides for non-residential buildings to be written off over 10 years, in a pattern so accelerated that 70 percent of the acquisition cost could be deducted in the first 5 years. Expenditures for most machinery and equipment could be fully written off, also in an accelerated pattern, over 5 years. A limited amount of expenditures for cars and light trucks used in businesses would be written off over a three-year period. This proposal would also liberalize the investment tax credit, by allowing the full 10 percent credit (instead of 6 2/3 percent) for equipment depreciated over 5 years, and a 6 percent credit (instead of 3 1/3 percent) for the 3-year class of assets. A phase-in over 5 years is proposed whereby the write-off periods, starting from a 1980 base, are reduced year-by-year. The 1980 lives are determined by reference to the current Asset Depreciation Range (ADR) system. Advocates of 10-5-3 argue that it would promote simplification and certainty, aid small business, and provide incentives for capital expansion. These are laudable goals, and should be considerations in evaluating any tax structure. Evaluation of our current system shows that there is room for improvement.

M-132

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The increase of 2.4 percent in real GNP for the third quarter of this year is further indication of strength in the economy, but prices continue to show rapid increase. I want to emphasize that the Administration intends to sustain a firm and consistent policy to reduce inflation. This policy has a number of aspects, but none is more important than the maintenance of strict fiscal discipline. At the present time, the action of steady budget pressure to slow the rate of inflation offers the strongest promise of restoring the health of our economy, reducing economic uncertainty, and reversing expectations for future inflation.

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Looking specifically at the 10-5-3 proposal, I would first point out that it would have a massive budget impact. The cost of S.1435 rises from about \$4 billion in the first year to over \$50 billion in 1984 and over \$85 billion in 1988 (see Table 1).

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The present tax depreciation system is cumbersome and complex. It involves a number of choices and uncertainties, and is especially burdensome for small businesses. It should be simplified. The present system provides an insufficient incentive for capital expansion in periods of rapid inflation and financial uncertainty. These incentives should be strengthened as much as our budget resources will allow.

Under the present rules, the business taxpayer is confronted with a myriad of choices. The first choice is whether to use the Asset Depreciation Range (ADR) System or to justify tax allowances on taxpayer's particular facts and circumstances. For those electing ADR, there is a choice of useful life within the allowable range for each class of assets. For all taxpayers there is also a choice of depreciation methods over the chosen lifetime. For some types of assets, especially buildings, there may be no ADR class and there may be a restricted choice of methods. With regard to types of equipment having allowable lives less than 7 years, the taxpayer must choose whether to forego some portion of the investment tax credit in favor of more rapid write-off. For large firms having computerized accounting systems, these options present no formidable problems. They elect ADR, using the most rapid method of depreciation, and the shortest available useful life after taking account of the investment credit rules. These large firms own the great bulk of depreciable assets.

A very small percentage of small business taxpayers have chosen to elect the ADR system. Despite recent changes in regulations to reduce requirements for reporting, small businesses apparently believe that ADR dictates a more complicated accounting system and involves more complex regulations. If these small businesses choose not to elect

ADR, but to use the shorter lives that are allowed without question to ADR electors--and we believe many small businesses so choose--they face the possibility that upon audit they may be required to justify those lives on facts and circumstances. For these reasons, small businesses may regard the ADR system as not addressed to their needs and circumstances.

Productivity and Investment

The stimulation of investment and improvement of productivity performance must be among the foremost objectives of economic policy. The share of business fixed investment in GNP has varied around a nearly flat trend for about the last 15 years (Chart 1). However, in the last expansion it neither grew as rapidly nor reached as high a peak as during the previous cycle that peaked in 1974. Investment in nonresidential structures has shown a persistent downward trend since 1966, while the equipment component has tended to increase as a percentage of GNP. This is partly explained by mandated expenditures for pollution control equipment, which are now about 7 percent of equipment spending.

Aggregate productivity growth has exhibited a pronounced decline in the last decade and output per hour worked is now well below its post-war trend (Chart 2). For the 20 years ending 1968, the annual rate of growth in output per hour worked was about 2 1/2 percent. More recently, and beginning even before the oil embargo and the recession of 1974 and 1975, the rate of this productivity growth has markedly slowed. In the years 1968 through 1973 the growth rate was only about 1 3/4 percent.

In the last recovery cycle, the upturn in productivity growth that normally accompanies expansion occurred later and was generally weaker than in other post-war recoveries (Chart 3). The average for this latest period, 1973-78 was an annual productivity gain of only one percent. This slowing of productivity growth has helped to perpetuate a spiral of inflationary wage price adjustments in the economy and has eroded our ability to compete in international markets.

While the recent growth in average productivity throughout the economy is unmistakably lower in recent years, this record is by no means uniform across major productive sectors (see Chart 4). The communications sector has experienced rapid and even accelerating growth in productivity throughout the period, while at the other

extreme, the construction industries have suffered declines in productivity in absolute terms since the late sixties, particularly over the most recent years. Among the public utilities, productivity growth has also slowed markedly since the late 1960s after rapid and steady increases up to that time. The record in manufacturing also shows a decline in the productivity growth throughout the 1970s but that growth has continued up to the present time, except for a one-year downturn in 1974. In the trade sector, output per hour has grown at less than a 2 percent annual rate over the entire period and is nearly flat in recent years.

Within the manufacturing sector, productivity growth has been and continues to be somewhat stronger in non-durables manufacturing as compared to the durables sector (see Chart 5). Among the durable goods industries the record of the motor vehicle industry has been particularly strong since 1974, while a pronounced decline in productivity has occurred in that same period for the primary metals industry.

The wide diversity in productivity gains across sectors and industries illustrates the importance of looking behind the aggregate trends. To the extent that declines in productivity in particular sectors can be attributed to lagging capital formation, we should pay close attention to the distribution of tax incentives among sectors of the economy, in addition to the aggregate amount of incentive. This is not to suggest that we attempt to direct all of the tax relief to particular industries that have poor productivity records (or those that have performed well) in the recent past but we should know the degree to which any proposal matches the incentives to the economic objectives.

Acceleration of depreciation allowances can be effective in providing investment stimulus. The direct tax savings that accompany the acquisition of capital provides additional cash flow to business firms for further investment and replacement. It is as if interest-free loans from the government were provided in the early years of a capital asset's use to be repaid out of the future productive output of these assets. These accelerated deductions reduce the "tax wedge" that is interposed between the returns to the physical investment and the rewards that can be paid to those who supply funds for investment. The reduction in the tax wedge reduces the cost of capital and, thereby, increases the amount of capital that can be profitably employed for the benefit of the company, its employees, and its customers.

The Concept of Capital Recovery

Before I get to a specific analysis of some of its likely consequences of the 10-5-3 proposal, I would like to discuss briefly the concept of capital recovery allowances. Many people regard depreciation as an arcane topic involving "useful lives," complicated formulas such as double declining balance and sum-of-years-digits, vintage accounting, and numerous other technicalities. Although the subject of depreciation is replete with imposing terminology, the underlying concept is straightforward. Depreciation is a cost of employing capital; as such, it must be deducted to arrive at net income, the same way that a wage deduction is taken for payments for labor.

In order to impose a tax on net income, the timing of receipts and expenses must be matched, and this requires that the cost of assets be deducted as they are consumed by use in a business. The Internal Revenue Code provides that there shall be a reasonable allowance for exhaustion, wear and tear, and obsolescence.

Of course, the determination of capital recovery allowances in any tax system is more difficult than for wage deductions because there is no current payment that measures the exact amount of capital consumed from one year to the next. The cost of depreciation each year is, therefore, estimated to be some proportion of the acquisition, or historical, cost of the asset. Inflation, however, increases capital consumption as measured in current dollars, and, therefore, depreciation allowances based on historical cost may be inadequate. Acceleration of tax depreciation may compensate for the general understatement of depreciation.

If the allowable depreciation deduction is greater for any year than the amount of capital consumed, the government is in effect extending an interest-free loan to the business. In the opposite case, inadequate depreciation allowance will prematurely increase taxable income, impose prepayment of taxes, and reduce internal cash flow.

The Effects of 10-5-3

The 10-5-3 proposal is a major departure from current practice in the determination of depreciation or capital recovery allowances. It would allow a large share of the acquisition cost of equipment and structures to be deducted for tax purposes much more rapidly than currently. The proposal deals with the problem of complexity by

substituting a single mandatory system in place of the existing complex of choices. The proposed system has simple categories, certain recovery periods, and a fully prescribed pattern of recovery allowances. This approach to both investment incentives and simplification deserves consideration, but there are deficiencies that should be examined carefully.

For example, the proposal is not as simple as it first appears. As drafted, the 10-5-3 proposal would have to establish mandatory guidelines lives during the five year phase-in that are tied to the ADR classification system. Each year, for five years, every taxpayer would apply a new schedule of depreciation rates to assets acquired in that year until they are fully written off. The phase-in rules also create a perverse incentive effect that postponement of investment until the following year will increase the rate of capital recovery allowances. The phase-in is intended to postpone the revenue losses, but it also increases complexity and uncertainty. To the extent that investment is delayed, feedback revenues are also delayed.

When the 10-5-3 rules are fully effective, their combination of rapid write-offs of and increased investment credit for machinery and equipment would be very generous, indeed. The investment credit would immediately pay for 10 percent of the cost of acquiring new equipment. Then 76 percent of the gross cost could be written off in the first three years; the entire amount in 5 years. The present value of the tax saving from the combination of the investment credit and the accelerated deductions is greater than full, first-year write-off would be. The treatment of equipment under 10-5-3 would be better for the taxpayer than immediate expensing.

Such a dramatic increase in capital allowance is not only expensive in terms of the budget, but it could also greatly increase tax shelter activity. The proposed deductions and credits would be most attractive to high-income individuals who could obtain the tax benefits through net leasing of machinery and equipment. Tax shelter opportunities could also increase for those investing in buildings, such as offices and shopping centers, as the proposed bill both shortens the recovery period for these buildings and accelerates the depreciation method. A tougher recapture rule for buildings is proposed in the bill, but this only offsets a portion of the potential tax-shelter benefits.

Another result of 10-5-3 is a wide range of differential benefits among businesses according to the types of assets that they use and their present industry classification. For example, machinery and equipment (other than automobiles and light trucks) are now depreciated as if they had an average depreciation lifetime of 10.2 years (Table 2); the recovery period prescribed in S. 1435 is less than half that current average. For buildings, present practice is equivalent to an average lifetime of 32.6 years. The proposal would allow these buildings to be written off in less than one-third that time. For autos and light trucks, the reduction is relatively small from 3.5 years to 3.0 years, although, in many cases, autos and trucks would benefit from an increase in the investment credit.

The variation in benefits provided by 10-5-3 is most pronounced when industry categories are compared. After the five year phase-in, all major industry classes would have higher depreciation allowances under 10-5-3. However, the share of projected total investment "paid for" by accelerated depreciation is generally higher for those industries employing longer-lived assets. For machinery and equipment, you can see (Table 2) that the reduction in the recovery period is minimal in the case of construction and very small for manufacture of motor vehicles. Toward the other end of the spectrum, the recovery period for assets used in the primary metals industry would be nearly half the present ADR lives, communications would be about one-third, and public utilities about one-fourth. (Table 3 attached to this statement provides quarter industry detail.)

The Treasury Department has simulated changes in depreciation periods, together with the changes in the investment credit, to estimate potential tax savings during the period of phase-in. These estimates are then used to compute the tax saving per dollar of projected investment. Not surprisingly, the relative magnitudes generally follow in the same order as the degree of reduction in write-off periods (Chart 6). In 1984, the tax saving per dollar of projected investment in the construction industry would be less than 5 percent; for motor vehicles it is 8 percent; for primary metals it is around 15 percent; for communications just less than 20 percent; and the tax saving would pay for more than 20 percent of investment in the public utilities.

You may wonder about the apparent revenue increase in motor vehicle manufacturing for 1981. This results from a phase-in rule that immediately increases the recovery period for the auto companies' special tools from three years up to five years. In later years, the year-by-year reduction prescribed for longer-lived assets becomes dominant.

Highway transportation, services, agriculture, wholesale and retail trade, fabricated metals, and electronics are among other industries with relatively smaller benefits (Table 4). Among the other larger gainers are railroads, shipping, and oil pipelines.

The benefits estimated here are "potential" in the sense that no allowance is made for the possibility that certain companies will have insufficient tax liabilities against which to take the full amount of any additional deduction. Likewise, the estimates for public utilities take no account of the rule that disallows the use of 10-5-3 to utilities that "flow through" the benefits of accelerated depreciation to consumers.

Among industries with relatively poor productivity performance over the last five years, the construction industry has the smallest amount of potential benefit from 10-5-3 among all industries and utilities has the largest (Chart 7). Looking at the stronger productivity sectors, communication is among the larger gainers from 10-5-3, while communications and motor vehicles are among the more modest beneficiaries. In general, there is no discernible relationship between the amount of additional capital formation incentive provided by 10-5-3 and the relative strength of productivity performance over the past five years. The point here is not that these should be exactly matched, but rather that it is very difficult to see any purpose to the vastly different amounts of investment incentive provided across industries by 10-5-3.

I do not come to you today with any specific proposal nor, in view of the deficiencies of 10-5-3, can I support S.1435. I am obviously concerned about the large revenue cost, and the implication that greatly differing amounts of investment stimulus would be scattered about indiscriminantly among industries and asset types.

The simplification objectives of 10-5-3 could be achieved through other depreciation proposals. I would further suggest that you should consider the continuation of some administrative mechanism for the system to assure that the capital recovery deductions allowed for tax purposes are consistent with changes in true depreciation costs. I believe we should analyze carefully a wide range of depreciation plans, and I will continue to develop and work with you to promote a depreciation or capital recovery system that we can all regard as simple, effective and fair. Such a system should be put into effect as soon as budgetary resources and prudent fiscal policy permit.

Table 1

Revenue Estimates
(\$Billions)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Change in Tax Liability - Calendar Years										
Corporate	-3.2	-8.5	-17.9	-29.9	-44.1	-57.2	-67.6	-72.9	-73.3	-70.9
Individual	-0.6	-1.5	-3.2	-5.3	-7.8	-10.1	-11.9	-12.9	-12.9	-12.5
Total	-3.8	-10.0	-21.1	-35.2	-51.9	-67.3	-79.5	-85.8	-86.2	-83.4
Change in Receipts - Fiscal Years										
Corporate	-1.5	-5.6	-12.7	-23.3	-36.2	-49.8	-61.7	-69.8	-73.0	-72.1
Individual	-0.2	-0.9	-2.1	-4.0	-6.2	-8.7	-10.8	-12.3	-12.9	-12.8
Total	-1.7	-6.5	-14.8	-27.3	-42.4	-58.5	-72.5	-82.1	-85.9	-84.9
Office of the Secretary of the Treasury							October 19, 1979			
Office of Tax Analysis										

Chart 1

BUSINESS FIXED INVESTMENT AS PERCENT OF REAL GNP

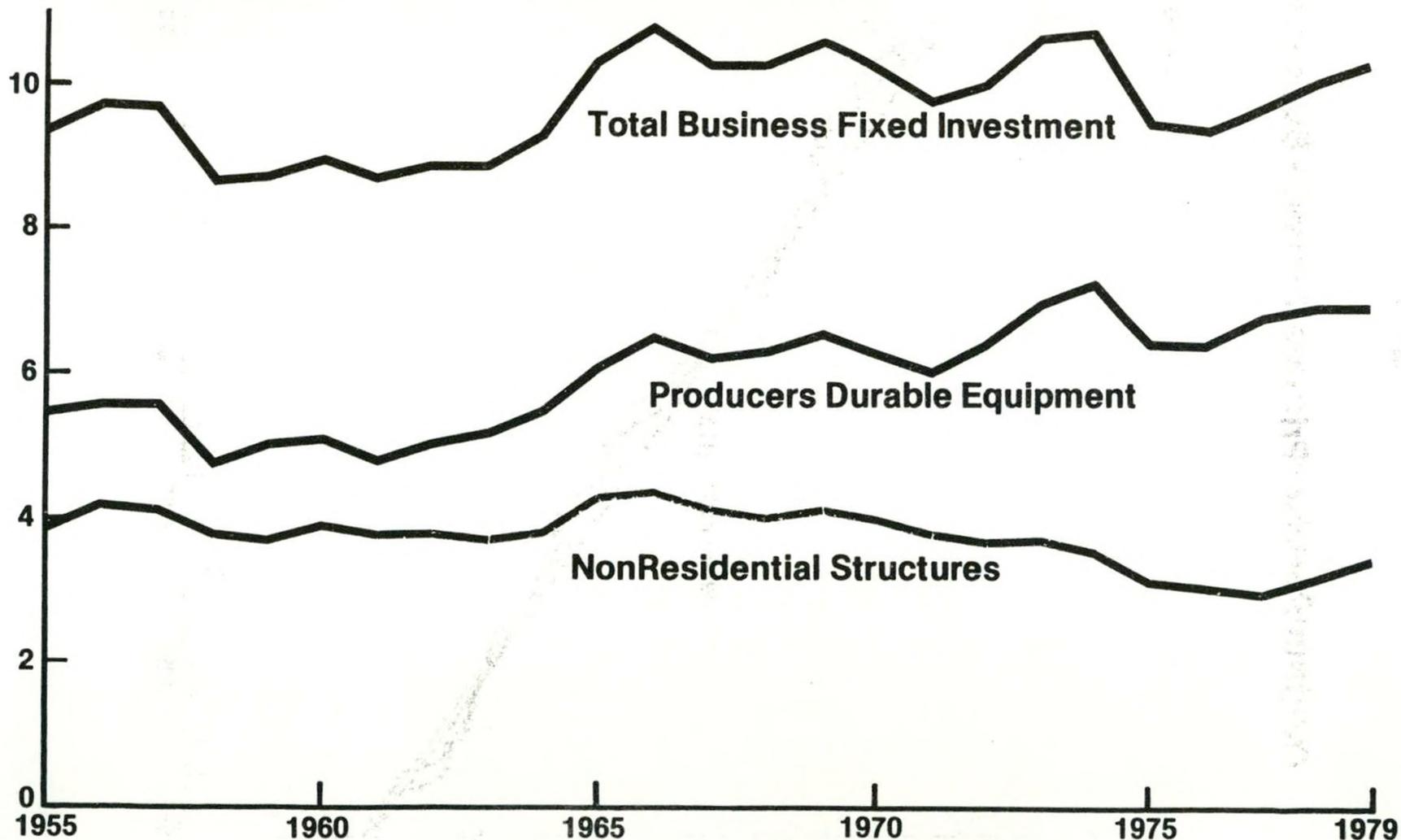
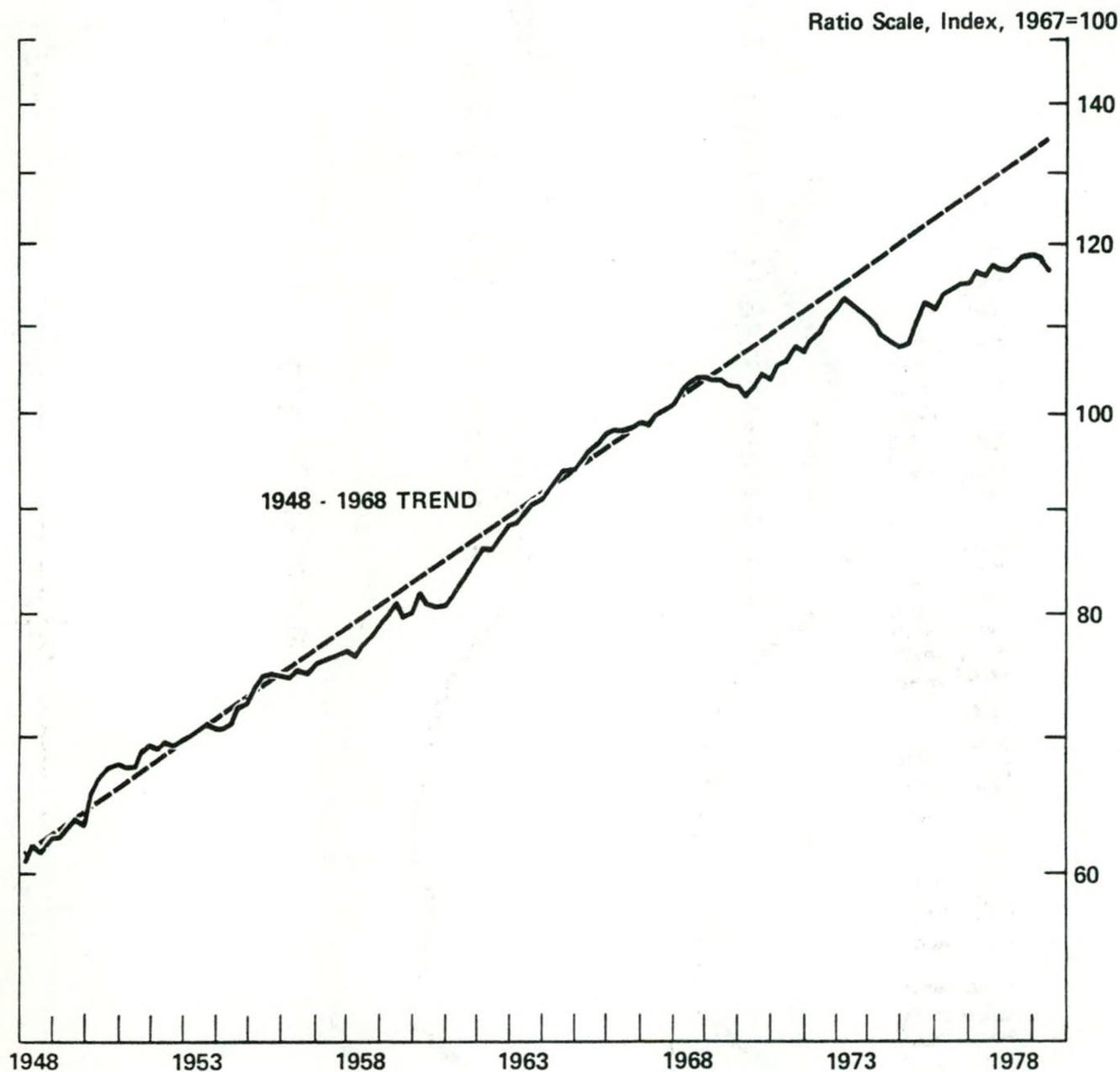
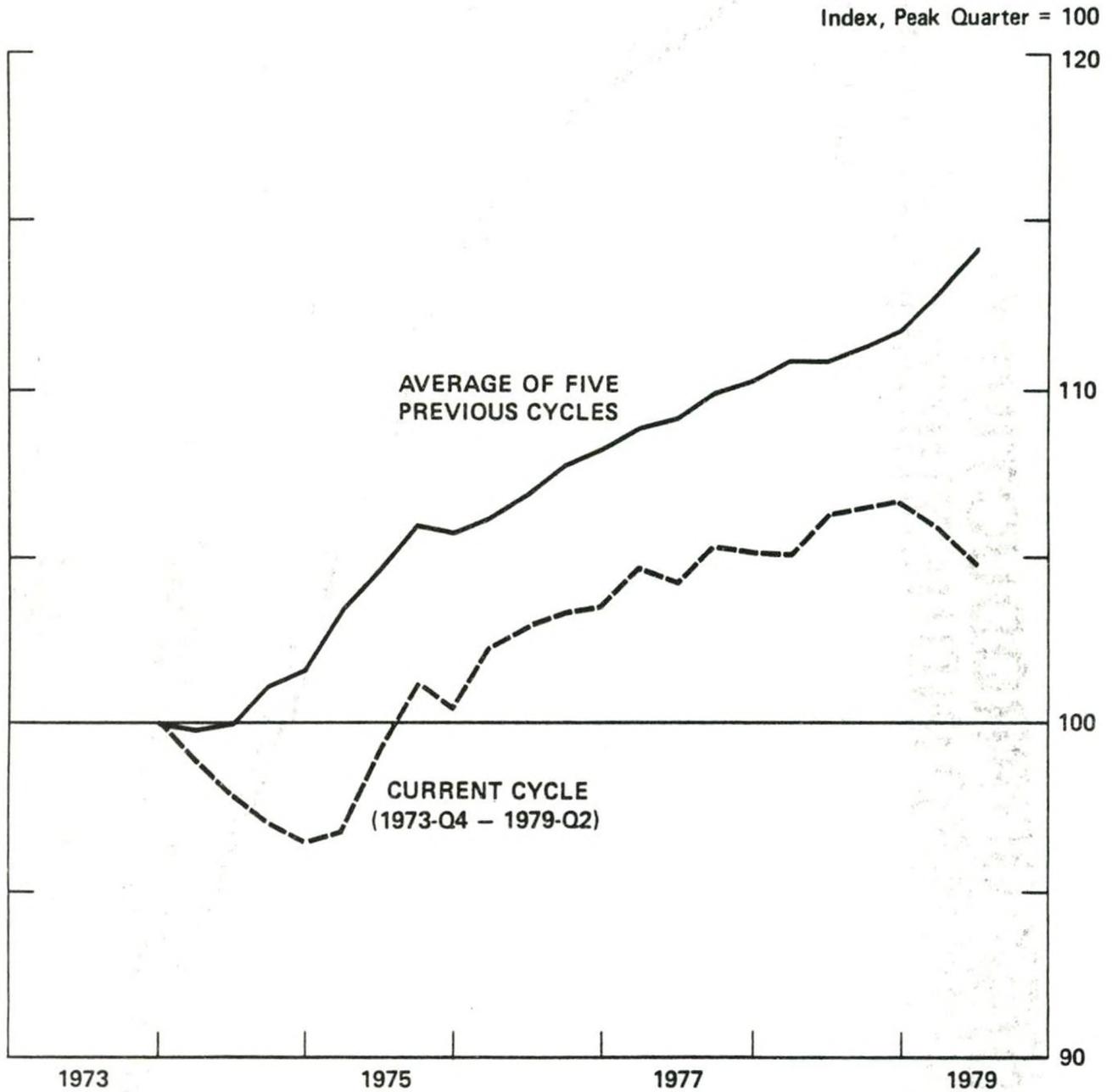


Chart 2

Output Per Hour, Private Nonfarm Business Sector



Cyclical Comparisons of Output Per Hour, Private Nonfarm Business Sector*



* Changes following the cyclical peaks as specified by NBER.

INDEX OF PRODUCTIVITY, SELECTED INDUSTRIES (1955=100)

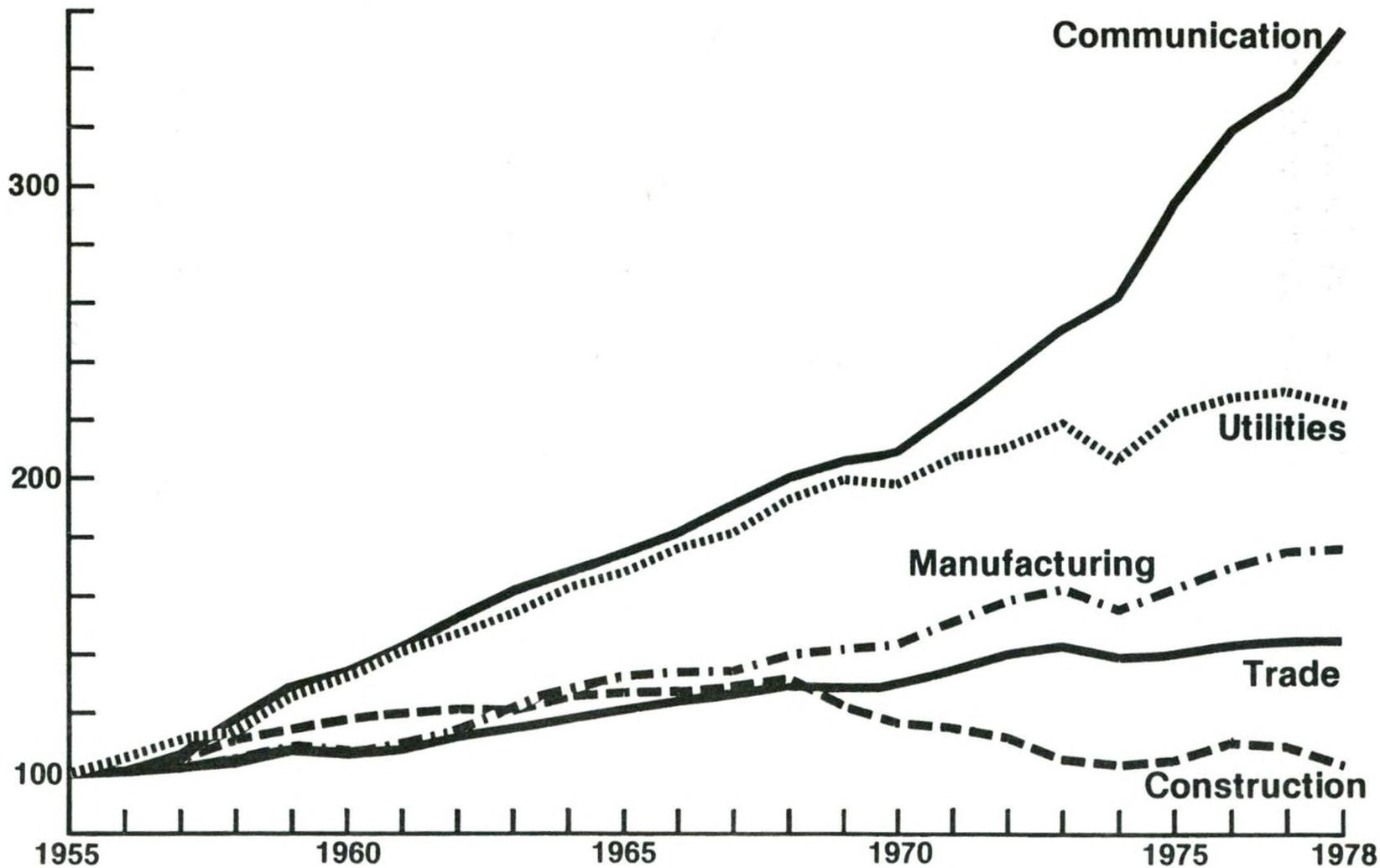


Chart 5

INDEX OF PRODUCTIVITY, SELECTED MANUFACTURING INDUSTRIES (1955=100)

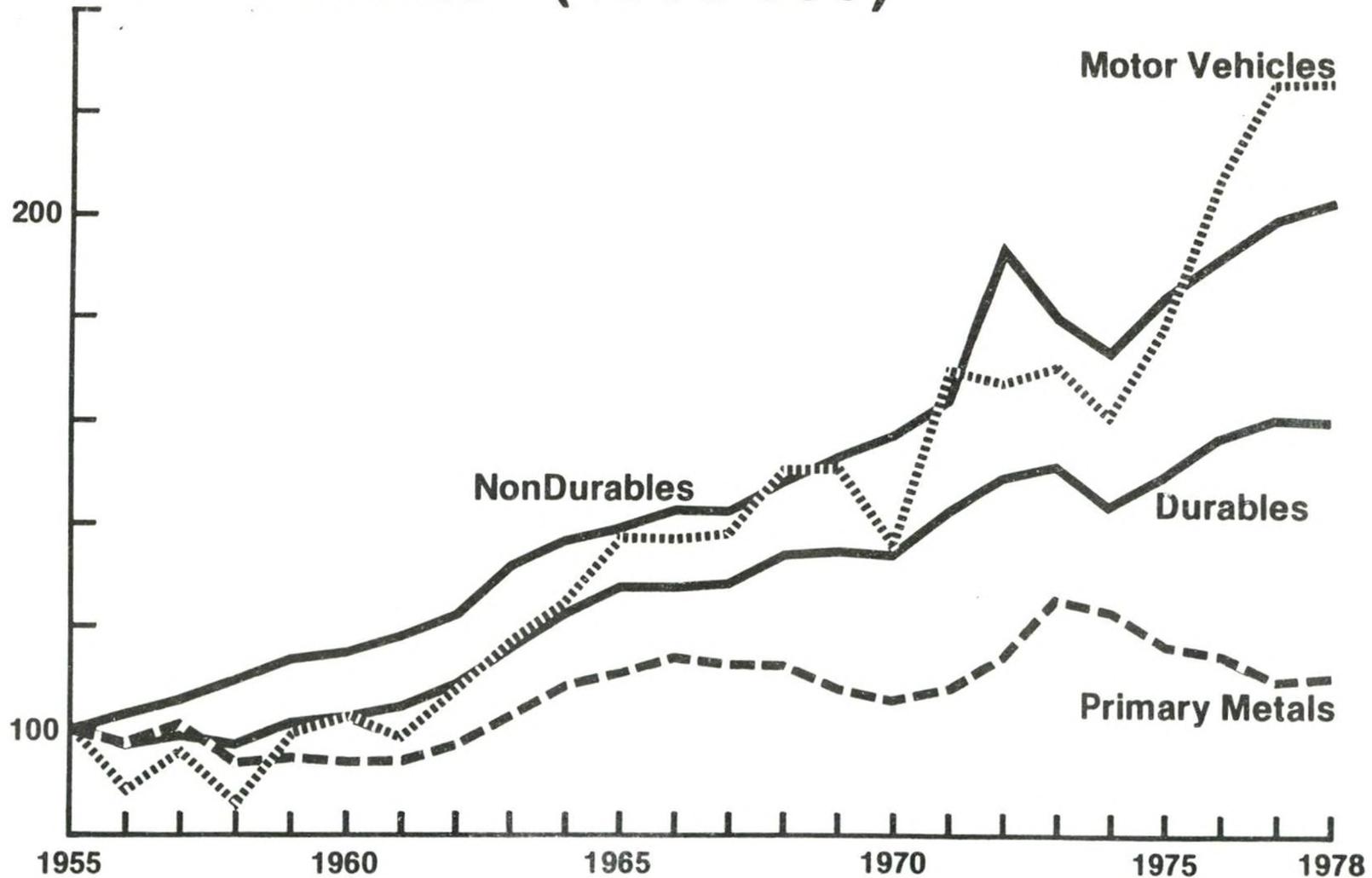


Table 2

“BEST ALLOWABLE” ADR DEPRECIATION PERIODS AS COMPARED TO 10-5-3 SELECTED INDUSTRIES

Asset Class	10-5-3		ADR				
	All Industries	All Industries	Construction	Motor Vehicles	Communication	Primary Metals	Utilities
Autos & Light Trucks	3	3.5	3.8	3.1	4.4	3.2	4.5
Other Machinery and Equipment	5	10.2	5.1	5.8	14.6	11.3	20.4
Buildings	10	32.6	35.0	35.0	36.0	35.0	35.0
Total	5.9	12.7					

Table 3

"Best Allowable" Depreciation Life (Years)
Under Present Law, by Industry

	Cars and Light Trucks	Machinery and Equipment	Building
All Industries	3.5	10.2	32.6
Agriculture	3.9	7.7	20.0
Construction	3.8	5.1	35.0
Oil and Gas			
Drilling	3.2	7.0	35.0
Production	3.2	11.0	35.0
Refining	3.4	12.4	35.0
Marketing	-	13.0	13.0
Mining	3.6	7.8	35.0
Manufacturing			
Food	3.2	9.2	35.0
Tobacco	3.3	11.4	35.0
Textiles	3.2	8.1	35.0
Apparel	3.1	7.1	35.0
Logging/Saw Mills	3.9	6.8	35.0
Wood Products	3.8	7.1	35.0
Pulp and Paper	3.2	9.9	35.0
Printing and publishing	3.1	8.7	35.0
Chemicals	3.1	7.7	35.0
Rubber Products	3.1	9.6	35.0
Plastic Products	3.0	8.0	35.0
Leather	3.0	8.5	35.0
Glass	3.0	9.2	35.0
Cement	3.5	14.0	35.0
Stone and Clay Products	3.5	10.9	35.0
Primary Metal	3.2	11.3	35.0
Fabricated Metal	3.1	4.9	35.0
Machinery	3.0	7.9	35.0
Electrical Machinery	3.0	9.3	35.0
Electronics	3.0	7.1	35.0
Motor Vehicles	3.1	5.8	35.0

"Best Allowable" Depreciation Life (Years)
Under Present Law, by Industry
(continued)

	Cars and Light Trucks	Machinery and Equipment	Buildings
Areospace	3.0	7.8	35.0
Shipbuilding	3.3	9.7	35.0
Railroad Equipment	3.3	8.8	35.0
Instruments	3.1	9.0	35.0
Other	3.1	9.0	35.0
Transportation			
Rail	-	11.7	-
Air	-	9.4	35.0
Water	-	15.7	35.0
Highway	3.4	5.6	35.0
Communication	4.4	14.6	36.0
Utilities			
Electric	4.5	20.5	35.0
Gas	4.5	23.1	35.0
Pipeline	-	17.5	35.0
Wholesale and Retail Trade	3.5	6.8	35.0
Services	3.3	7.8	35.0
Amusements	3.0	9.8	35.0

Note: The "best allowable" depreciation period for an industry is a special type of weighted average of the best available depreciation periods (taking account of the investment credit effects of lives lower than five or seven years) for equipment used in the industry. The weights are estimated 1976 investment in the several types of equipment. The weighted average takes account of the time value of tax saving. In the case of buildings not covered by ADR, the best available depreciation period is assumed to be 35 years, which is approximately the average useful life employed by taxpayers, as revealed by Treasury Department surveys in 1972 and 1973.

TAX SAVINGS DUE TO 10-5-3 PER DOLLAR OF PROJECTED INVESTMENT IN DEPRECIABLE ASSETS ; 1980, 1981, AND 1984, SELECTED INDUSTRIES

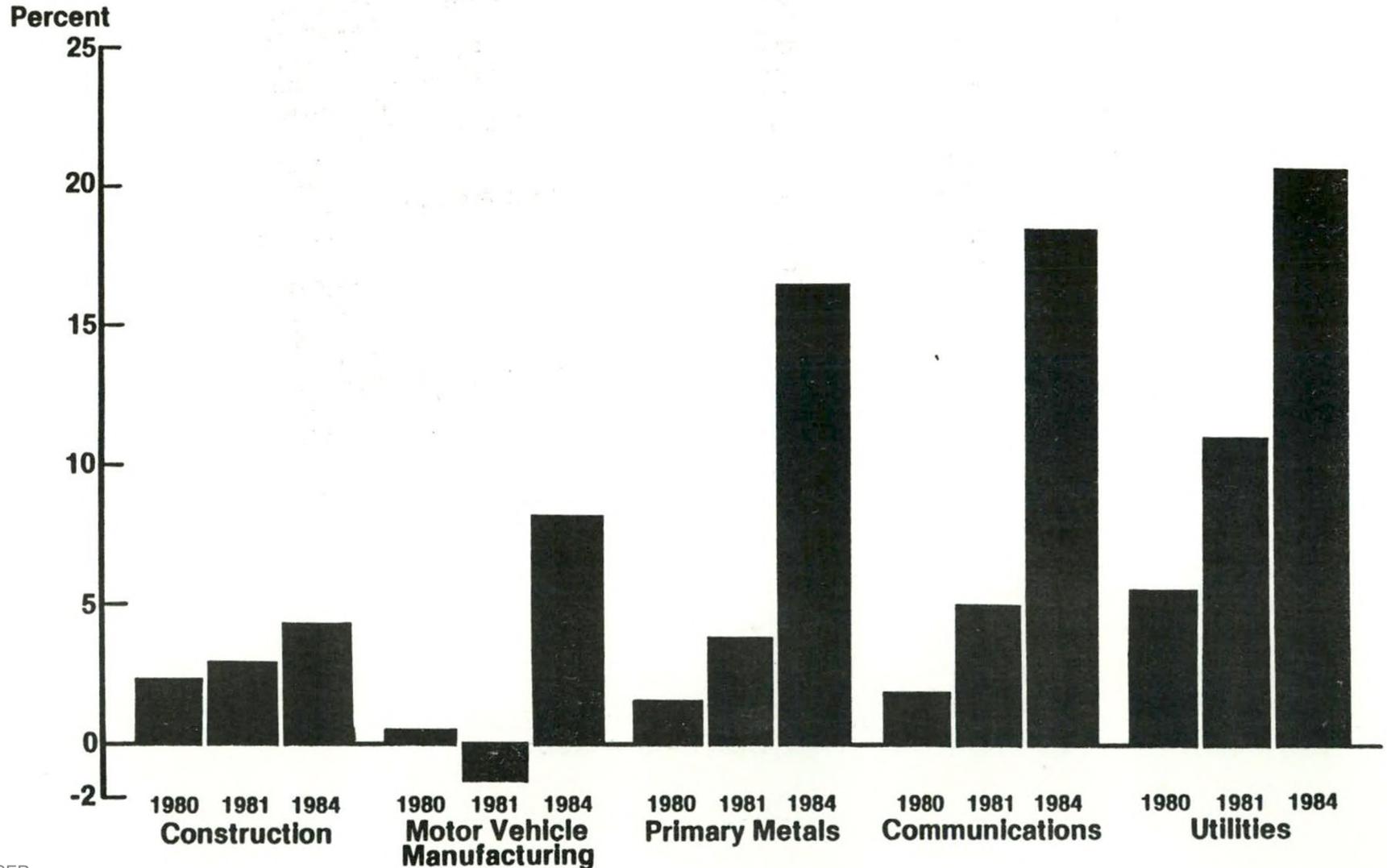


Table 4

Estimated Tax Reduction Due to 10-5-3
as a Percent of Projected Investment 1/, 1984

Industry Class	Estimated 1984 Tax Reduction (\$ Millions)	Projected 1984 Investment (\$ Millions)	1984 Tax Reduction As Percent of Investment
Manufacturing:			
Non-durables	5,729	50,016	11.5
Food	1,258	10,624	11.8
Tobacco	50	369	13.6
Textiles	332	2,757	12.0
Apparel	121	1,196	10.1
Pulp and Paper	837	7,777	10.8
Printing and Publishing	341	3,390	10.1
Chemicals	2,345	19,838	11.8
Rubber	123	927	13.3
Plastics	303	2,918	10.4
Leather	16	220	7.3
Durables			
Wood Products and Furniture	5,606	51,496	10.9
Cement	98	2,100	4.7
Glass	90	622	14.5
Other Stone and Clay	146	1,258	11.6
Ferrous Metals	281	2,150	13.1
Non-ferrous Metals	1,107	6,739	16.4
Fabricated Metals	421	3,004	14.0
Machinery	504	6,587	7.7
Electrical Equipment	950	8,345	11.4
Electronics	493	4,448	11.1
Motor Vehicles	266	2,884	9.2
Motor Vehicles	458	5,716	8.0
Aerospace	182	1,591	11.4

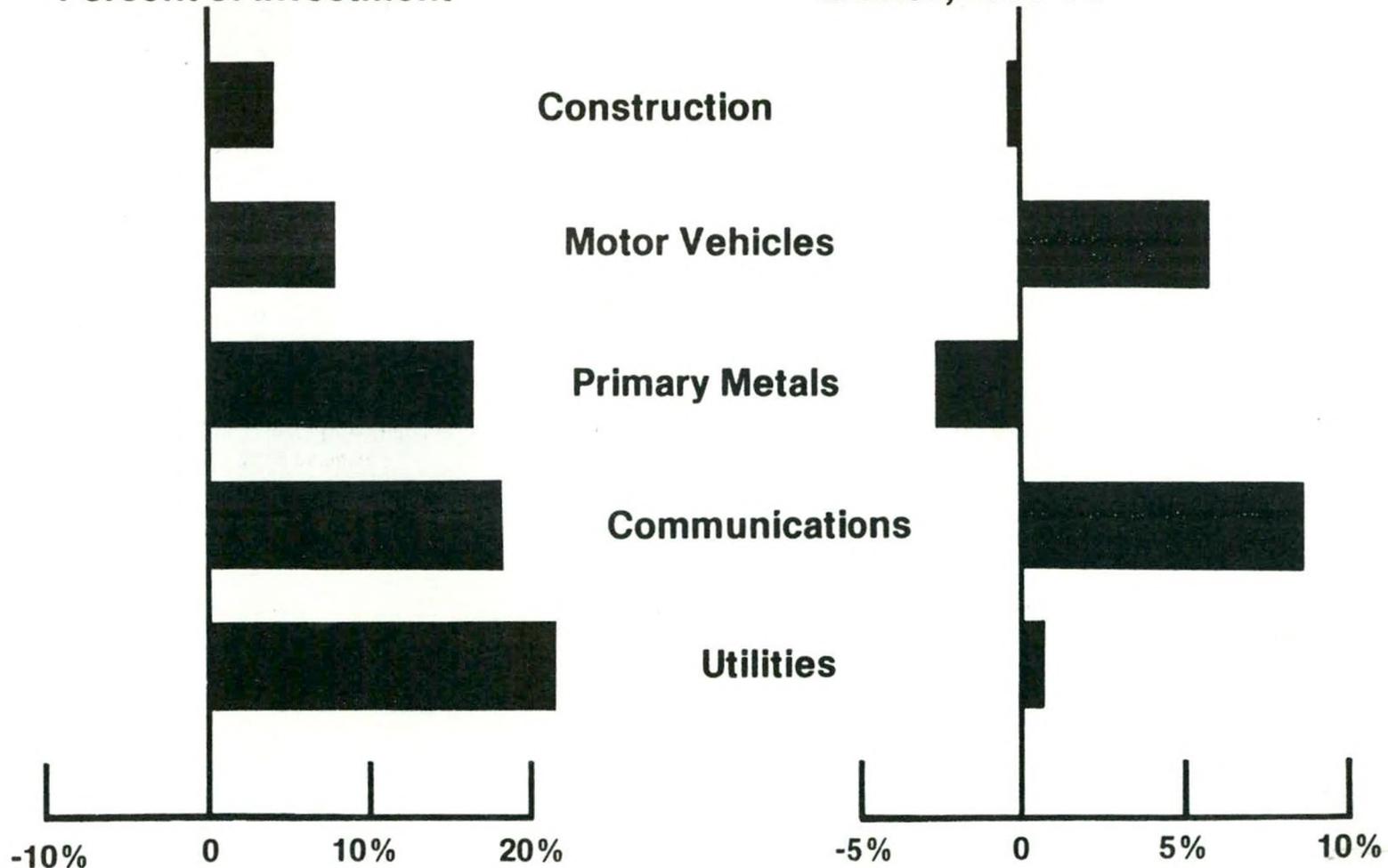
1/ Estimates of investment by purchasing sector are based on Annual Survey of Manufacturers, 1976, and data from regulatory agencies, trade associations, and other industry sources.

Industry Class	Estimated 1984 (\$Millions)	Projected 1984 (\$Millions)	1984 Tax Reduction As Percent of Investment
Shipbuilding	169	1,534	11.0
Railroad Equipment	17	129	13.2
Instruments	222	2,383	9.3
Other Manufacturing	202	2,006	10.1
Transportation	4,048	40,504	10.0
Railroads	562	3,362	16.7
Airlines	814	6,175	13.2
Water Transport	1,432	9,492	15.1
Highway Transport	1,240	21,475	5.8
Communication	5,956	32,130	18.5
Utilities	9,162	42,187	21.7
Electric Utilities	7,533	35,853	21.0
Gas Utilities and Pipelines	1,629	6,334	25.7
Mining, except oil and gas	1,120	10,796	10.4
Oil and Gas Drilling	238	2,945	8.1
Oil and Gas Production	5,079	38,390	13.2
Petroleum Refining	1,207	8,785	13.7
Petroleum Marketing	142	1,254	11.3
Oil Pipelines	2,202	10,175	21.6
Construction	1,114	25,085	4.4
Wholesale and Retail Trade	3,823	44,097	8.7
Agriculture	2,069	27,220	7.6
Services	3,337	41,109	8.1
Grand Total	51,912	435,725	11.9

BENEFITS OF 10-5-3 AS COMPARED TO RECENT GROWTH IN PRODUCTIVITY, SELECTED INDUSTRIES

1984 Tax Saving as
Percent of Investment

Average Annual Productivity
Growth, 1973-78





FOR RELEASE UPON DELIVERY
October 22, 1979 10:00 AM EDST

TESTIMONY OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY

BEFORE THE SUBCOMMITTEE OF TAXATION
AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

Thank you for inviting me to discuss S. 1435, a very significant proposal to restructure the system of depreciation allowances. I am pleased to see the broad interest in legislation to encourage capital formation and increase productivity.

The 10-5-3 proposal would restructure the system of tax allowances for capital recovery. It would greatly shorten the periods over which most capital expenditures can be written off. The proposal provides for non-residential buildings to be written off over 10 years, in a pattern so accelerated that 70 percent of the acquisition cost could be deducted in the first 5 years. Expenditures for most machinery and equipment could be fully written off, also in an accelerated pattern, over 5 years. A limited amount of expenditures for cars and light trucks used in businesses would be written off over a three-year period. This proposal would also liberalize the investment tax credit, by allowing the full 10 percent credit (instead of 6 2/3 percent) for equipment depreciated over 5 years, and a 6 percent credit (instead of 3 1/3 percent) for the 3-year class of assets. A phase-in over 5 years is proposed whereby the write-off periods, starting from a 1980 base, are reduced year-by-year. The 1980 lives are determined by reference to the current Asset Depreciation Range (ADR) system. Advocates of 10-5-3 argue that it would promote simplification and certainty, aid small business, and provide incentives for capital expansion. These are laudable goals, and should be considerations in evaluating any tax structure. Evaluation of our current system shows that there is room for improvement.

M-132

Economic Background

The increase of 2.4 percent in real GNP for the third quarter of this year is further indication of strength in the economy, but prices continue to show rapid increase. I want to emphasize that the Administration intends to sustain a firm and consistent policy to reduce inflation. This policy has a number of aspects, but none is more important than the maintenance of strict fiscal discipline. At the present time, the action of steady budget pressure to slow the rate of inflation offers the strongest promise of restoring the health of our economy, reducing economic uncertainty, and reversing expectations for future inflation.

I believe that a commitment to widen the budget deficit by the magnitude of S. 1435 would be premature at this time. However, we should study possibilities for a program that will promote longer-range economic objectives as effectively and fairly as possible. At the appropriate time, you should be prepared to act on a program carefully structured to expand economic capacity, to reduce production costs, and to promote productivity. Appropriate depreciation allowances can help to accomplish these goals and should be given serious consideration as an element of any future tax package.

Revenue Costs of 10-5-3

Looking specifically at the 10-5-3 proposal, I would first point out that it would have a massive budget impact. The cost of S.1435 rises from about \$4 billion in the first year to over \$50 billion in 1984 and over \$85 billion in 1988 (see Table 1).

These estimates have been carried out further into the future than we would normally show in order to see the full effect of the proposed phase-in rules. Because the program would be implemented gradually during the first five years, it is not until 1984 that the full benefit of the more liberal depreciation allowances would be given to investment for any one year. For this reason, the revenue costs continue to build until 1988, after which revenue losses begin to fall. Eventually, the level of these losses stabilizes and thereafter they grow at about the same rate as investment expenditures. By 1987, when corporate tax receipts are expected to be \$116.7 billion, S.1435 would provide corporate tax reduction of nearly half that amount. The total revenue cost also includes a reduction in individual income taxes resulting from deductions taken by unincorporated businesses. This is equal to about 15 percent of the total revenue cost.

The year-by-year revenue costs do not take account of the additional tax receipts resulting from economic expansion induced by the tax reductions. These "feedback" revenues amount to about 30 percent of the static revenue loss and are reflected primarily in increases in individual tax receipts. If these "feedback" revenues are taken into account, the result is a net revenue loss of about \$35 billion in 1984. It should be noted that the additional tax receipts that would be induced by this tax cut are about the same as that from any tax reduction having a comparable impact on GNP.

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ADR, but to use the shorter lives that are allowed without question to ADR electors--and we believe many small businesses so choose--they face the possibility that upon audit they may be required to justify those lives on facts and circumstances. For these reasons, small businesses may regard the ADR system as not addressed to their needs and circumstances.

Productivity and Investment

The stimulation of investment and improvement of productivity performance must be among the foremost objectives of economic policy. The share of business fixed investment in GNP has varied around a nearly flat trend for about the last 15 years (Chart 1). However, in the last expansion it neither grew as rapidly nor reached as high a peak as during the previous cycle that peaked in 1974. Investment in nonresidential structures has shown a persistent downward trend since 1966, while the equipment component has tended to increase as a percentage of GNP. This is partly explained by mandated expenditures for pollution control equipment, which are now about 7 percent of equipment spending.

Aggregate productivity growth has exhibited a pronounced decline in the last decade and output per hour worked is now well below its post-war trend (Chart 2). For the 20 years ending 1968, the annual rate of growth in output per hour worked was about 2 1/2 percent. More recently, and beginning even before the oil embargo and the recession of 1974 and 1975, the rate of this productivity growth has markedly slowed. In the years 1968 through 1973 the growth rate was only about 1 3/4 percent.

In the last recovery cycle, the upturn in productivity growth that normally accompanies expansion occurred later and was generally weaker than in other post-war recoveries (Chart 3). The average for this latest period, 1973-78 was an annual productivity gain of only one percent. This slowing of productivity growth has helped to perpetuate a spiral of inflationary wage price adjustments in the economy and has eroded our ability to compete in international markets.

While the recent growth in average productivity throughout the economy is unmistakably lower in recent years, this record is by no means uniform across major productive sectors (see Chart 4). The communications sector has experienced rapid and even accelerating growth in productivity throughout the period, while at the other

extreme, the construction industries have suffered declines in productivity in absolute terms since the late sixties, particularly over the most recent years. Among the public utilities, productivity growth has also slowed markedly since the late 1960s after rapid and steady increases up to that time. The record in manufacturing also shows a decline in the productivity growth throughout the 1970s but that growth has continued up to the present time, except for a one-year downturn in 1974. In the trade sector, output per hour has grown at less than a 2 percent annual rate over the entire period and is nearly flat in recent years.

Within the manufacturing sector, productivity growth has been and continues to be somewhat stronger in non-durables manufacturing as compared to the durables sector (see Chart 5). Among the durable goods industries the record of the motor vehicle industry has been particularly strong since 1974, while a pronounced decline in productivity has occurred in that some period for the primary metals industry.

The wide diversity in productivity gains across sectors and industries illustrates the importance of looking behind the aggregate trends. To the extent that declines in productivity in particular sectors can be attributed to lagging capital formation, we should pay close attention to the distribution of tax incentives among sectors of the economy, in addition to the aggregate amount of incentive. This is not to suggest that we attempt to direct all of the tax relief to particular industries that have poor productivity records (or those that have performed well) in the recent past but we should know the degree to which any proposal matches the incentives to the economic objectives.

Acceleration of depreciation allowances can be effective in providing investment stimulus. The direct tax savings that accompany the acquisition of capital provides additional cash flow to business firms for further investment and replacement. It is as if interest-free loans from the government were provided in the early years of a capital asset's use to be repaid out of the future productive output of these assets. These accelerated deductions reduce the "tax wedge" that is interposed between the returns to the physical investment and the rewards that can be paid to those who supply funds for investment. The reduction in the tax wedge reduces the cost of capital and, thereby, increases the amount of capital that can be profitably employed for the benefit of the company, its employees, and its customers.

The Concept of Capital Recovery

Before I get to a specific analysis of some of its likely consequences of the 10-5-3 proposal, I would like to discuss briefly the concept of capital recovery allowances. Many people regard depreciation as an arcane topic involving "useful lives," complicated formulas such as double declining balance and sum-of-years-digits, vintage accounting, and numerous other technicalities. Although the subject of depreciation is replete with imposing terminology, the underlying concept is straightforward. Depreciation is a cost of employing capital; as such, it must be deducted to arrive at net income, the same way that a wage deduction is taken for payments for labor.

In order to impose a tax on net income, the timing of receipts and expenses must be matched, and this requires that the cost of assets be deducted as they are consumed by use in a business. The Internal Revenue Code provides that there shall be a reasonable allowance for exhaustion, wear and tear, and obsolescence.

Of course, the determination of capital recovery allowances in any tax system is more difficult than for wage deductions because there is no current payment that measures the exact amount of capital consumed from one year to the next. The cost of depreciation each year is, therefore, estimated to be some proportion of the acquisition, or historical, cost of the asset. Inflation, however, increases capital consumption as measured in current dollars, and, therefore, depreciation allowances based on historical cost may be inadequate. Acceleration of tax depreciation may compensate for the general understatement of depreciation.

If the allowable depreciation deduction is greater for any year than the amount of capital consumed, the government is in effect extending an interest-free loan to the business. In the opposite case, inadequate depreciation allowance will prematurely increase taxable income, impose prepayment of taxes, and reduce internal cash flow.

The Effects of 10-5-3

The 10-5-3 proposal is a major departure from current practice in the determination of depreciation or capital recovery allowances. It would allow a large share of the acquisition cost of equipment and structures to be deducted for tax purposes much more rapidly than currently. The proposal deals with the problem of complexity by

substituting a single mandatory system in place of the existing complex of choices. The proposed system has simple categories, certain recovery periods, and a fully prescribed pattern of recovery allowances. This approach to both investment incentives and simplification deserves consideration, but there are deficiencies that should be examined carefully.

For example, the proposal is not as simple as it first appears. As drafted, the 10-5-3 proposal would have to establish mandatory guidelines lives during the five year phase-in that are tied to the ADR classification system. Each year, for five years, every taxpayer would apply a new schedule of depreciation rates to assets acquired in that year until they are fully written off. The phase-in rules also create a perverse incentive effect that postponement of investment until the following year will increase the rate of capital recovery allowances. The phase-in is intended to postpone the revenue losses, but it also increases complexity and uncertainty. To the extent that investment is delayed, feedback revenues are also delayed.

When the 10-5-3 rules are fully effective, their combination of rapid write-offs of and increased investment credit for machinery and equipment would be very generous, indeed. The investment credit would immediately pay for 10 percent of the cost of acquiring new equipment. Then 76 percent of the gross cost could be written off in the first three years; the entire amount in 5 years. The present value of the tax saving from the combination of the investment credit and the accelerated deductions is greater than full, first-year write-off would be. The treatment of equipment under 10-5-3 would be better for the taxpayer than immediate expensing.

Such a dramatic increase in capital allowance is not only expensive in terms of the budget, but it could also greatly increase tax shelter activity. The proposed deductions and credits would be most attractive to high-income individuals who could obtain the tax benefits through net leasing of machinery and equipment. Tax shelter opportunities could also increase for those investing in buildings, such as offices and shopping centers, as the proposed bill both shortens the recovery period for these buildings and accelerates the depreciation method. A tougher recapture rule for buildings is proposed in the bill, but this only offsets a portion of the potential tax-shelter benefits.

Another result of 10-5-3 is a wide range of differential benefits among businesses according to the types of assets that they use and their present industry classification. For example, machinery and equipment (other than automobiles and light trucks) are now depreciated as if they had an average depreciation lifetime of 10.2 years (Table 2); the recovery period prescribed in S. 1435 is less than half that current average. For buildings, present practice is equivalent to an average lifetime of 32.6 years. The proposal would allow these buildings to be written off in less than one-third that time. For autos and light trucks, the reduction is relatively small from 3.5 years to 3.0 years, although, in many cases, autos and trucks would benefit from an increase in the investment credit.

The variation in benefits provided by 10-5-3 is most pronounced when industry categories are compared. After the five year phase-in, all major industry classes would have higher depreciation allowances under 10-5-3. However, the share of projected total investment "paid for" by accelerated depreciation is generally higher for those industries employing longer-lived assets. For machinery and equipment, you can see (Table 2) that the reduction in the recovery period is minimal in the case of construction and very small for manufacture of motor vehicles. Toward the other end of the spectrum, the recovery period for assets used in the primary metals industry would be nearly half the present ADR lives, communications would be about one-third, and public utilities about one-fourth. (Table 3 attached to this statement provides quarter industry detail.)

The Treasury Department has simulated changes in depreciation periods, together with the changes in the investment credit, to estimate potential tax savings during the period of phase-in. These estimates are then used to compute the tax saving per dollar of projected investment. Not surprisingly, the relative magnitudes generally follow in the same order as the degree of reduction in write-off periods (Chart 6). In 1984, the tax saving per dollar of projected investment in the construction industry would be less than 5 percent; for motor vehicles it is 8 percent; for primary metals it is around 15 percent; for communications just less than 20 percent; and the tax saving would pay for more than 20 percent of investment in the public utilities.

You may wonder about the apparent revenue increase in motor vehicle manufacturing for 1981. This results from a phase-in rule that immediately increases the recovery period for the auto companies' special tools from three years up to five years. In later years, the year-by-year reduction prescribed for longer-lived assets becomes dominant.

Highway transportation, services, agriculture, wholesale and retail trade, fabricated metals, and electronics are among other industries with relatively smaller benefits (Table 4). Among the other larger gainers are railroads, shipping, and oil pipelines.

The benefits estimated here are "potential" in the sense that no allowance is made for the possibility that certain companies will have insufficient tax liabilities against which to take the full amount of any additional deduction. Likewise, the estimates for public utilities take no account of the rule that disallows the use of 10-5-3 to utilities that "flow through" the benefits of accelerated depreciation to consumers.

Among industries with relatively poor productivity performance over the last five years, the construction industry has the smallest amount of potential benefit from 10-5-3 among all industries and utilities has the largest (Chart 7). Looking at the stronger productivity sectors, communication is among the larger gainers from 10-5-3, while communications and motor vehicles are among the more modest beneficiaries. In general, there is no discernible relationship between the amount of additional capital formation incentive provided by 10-5-3 and the relative strength of productivity performance over the past five years. The point here is not that these should be exactly matched, but rather that it is very difficult to see any purpose to the vastly different amounts of investment incentive provided across industries by 10-5-3.

I do not come to you today with any specific proposal nor, in view of the deficiencies of 10-5-3, can I support S.1435. I am obviously concerned about the large revenue cost, and the implication that greatly differing amounts of investment stimulus would be scattered about indiscriminantly among industries and asset types.

The simplification objectives of 10-5-3 could be achieved through other depreciation proposals. I would further suggest that you should consider the continuation of some administrative mechanism for the system to assure that the capital recovery deductions allowed for tax purposes are consistent with changes in true depreciation costs. I believe we should analyze carefully a wide range of depreciation plans, and I will continue to develop and work with you to promote a depreciation or capital recovery system that we can all regard as simple, effective and fair. Such a system should be put into effect as soon as budgetary resources and prudent fiscal policy permit.

Table 1

Revenue Estimates
(\$Billions)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Change in Tax Liability - Calendar Years										
Corporate	-3.2	-8.5	-17.9	-29.9	-44.1	-57.2	-67.6	-72.9	-73.3	-70.9
Individual	-0.6	-1.5	-3.2	-5.3	-7.8	-10.1	-11.9	-12.9	-12.9	-12.5
Total	-3.8	-10.0	-21.1	-35.2	-51.9	-67.3	-79.5	-85.8	-86.2	-83.4
Change in Receipts - Fiscal Years										
Corporate	-1.5	-5.6	-12.7	-23.3	-36.2	-49.8	-61.7	-69.8	-73.0	-72.1
Individual	-0.2	-0.9	-2.1	-4.0	-6.2	-8.7	-10.8	-12.3	-12.9	-12.8
Total	-1.7	-6.5	-14.8	-27.3	-42.4	-58.5	-72.5	-82.1	-85.9	-84.9
Office of the Secretary of the Treasury							October 19, 1979			
Office of Tax Analysis										

Chart 1

BUSINESS FIXED INVESTMENT AS PERCENT OF REAL GNP

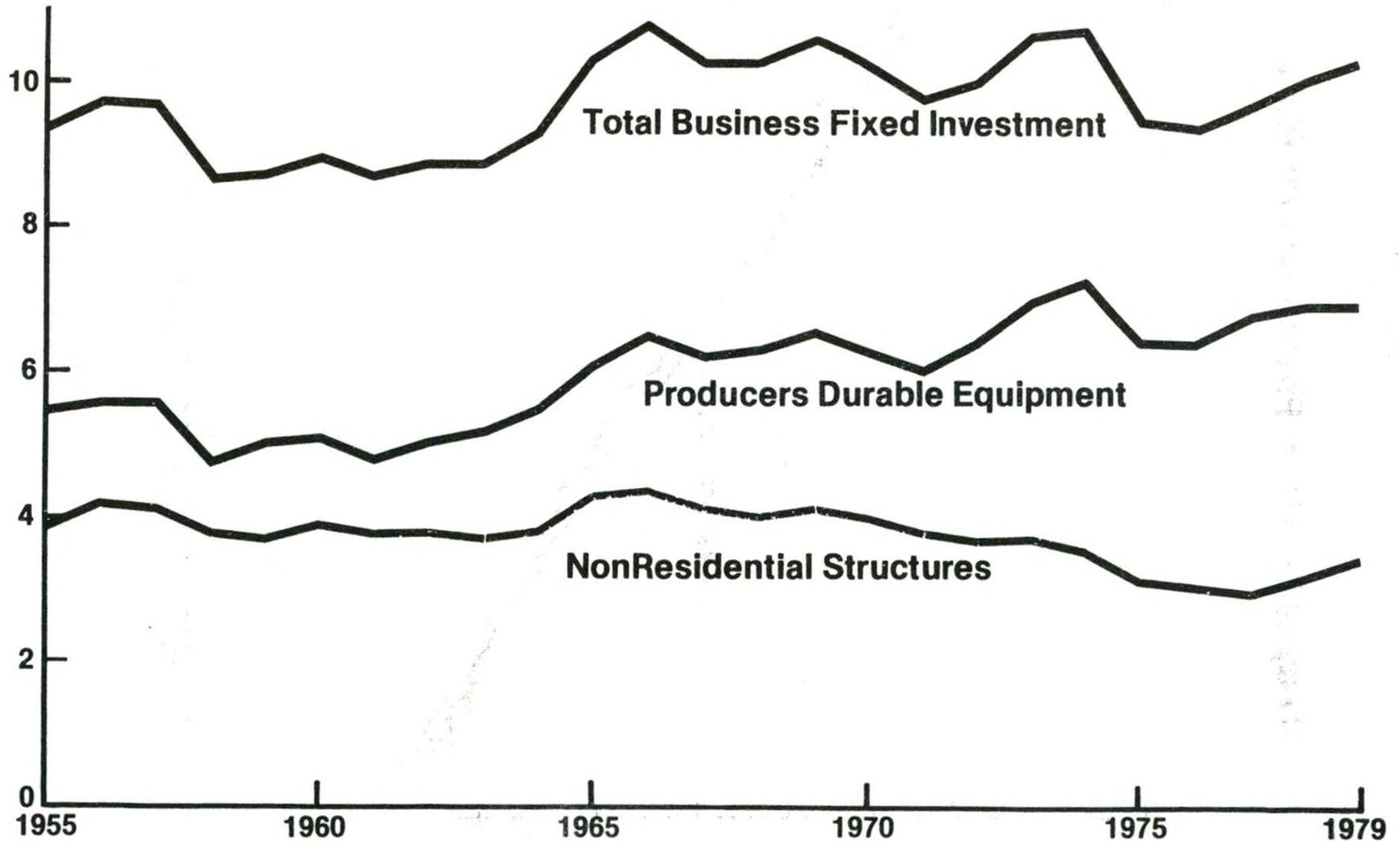


Chart 2

Output Per Hour, Private Nonfarm Business Sector

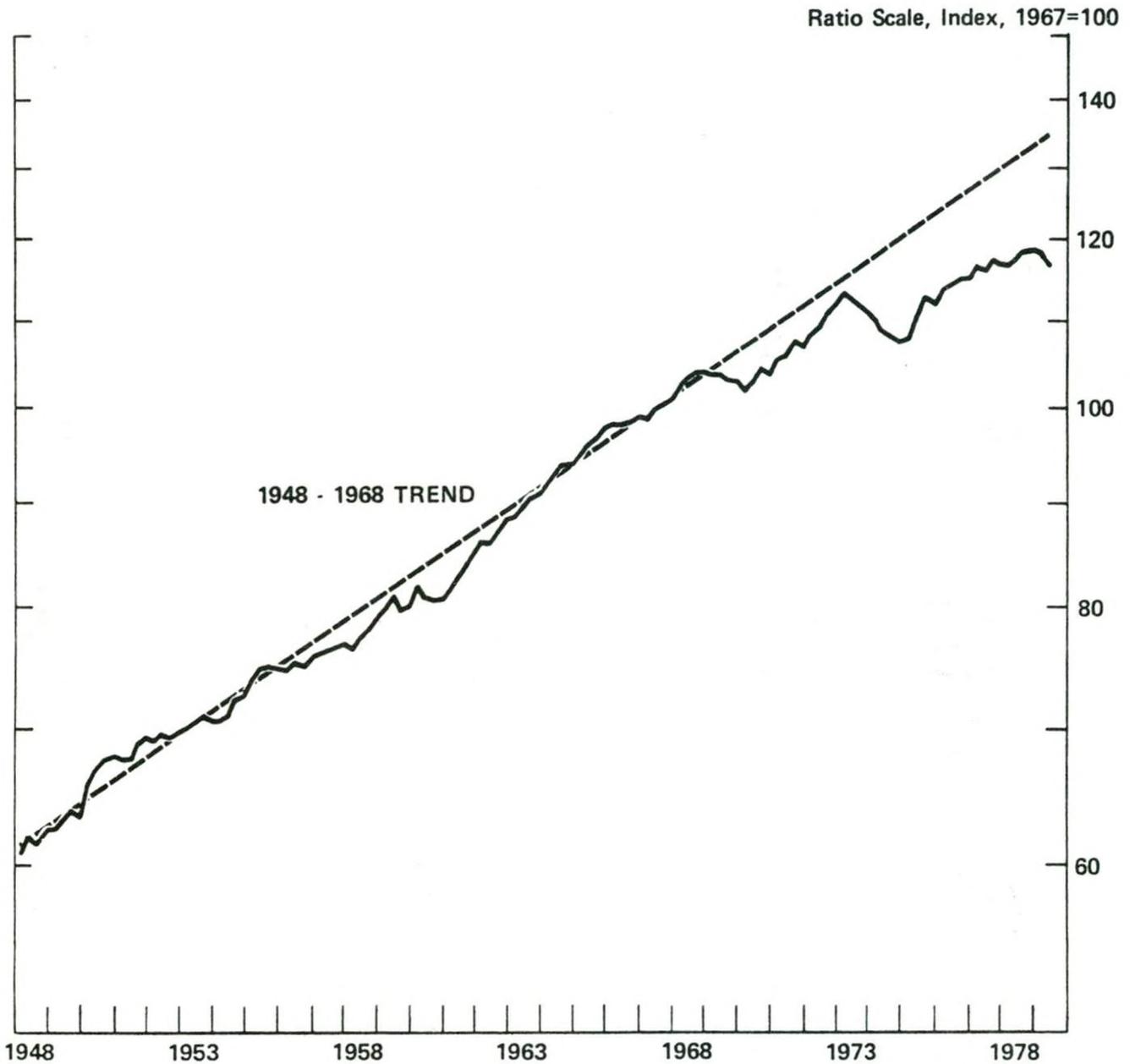
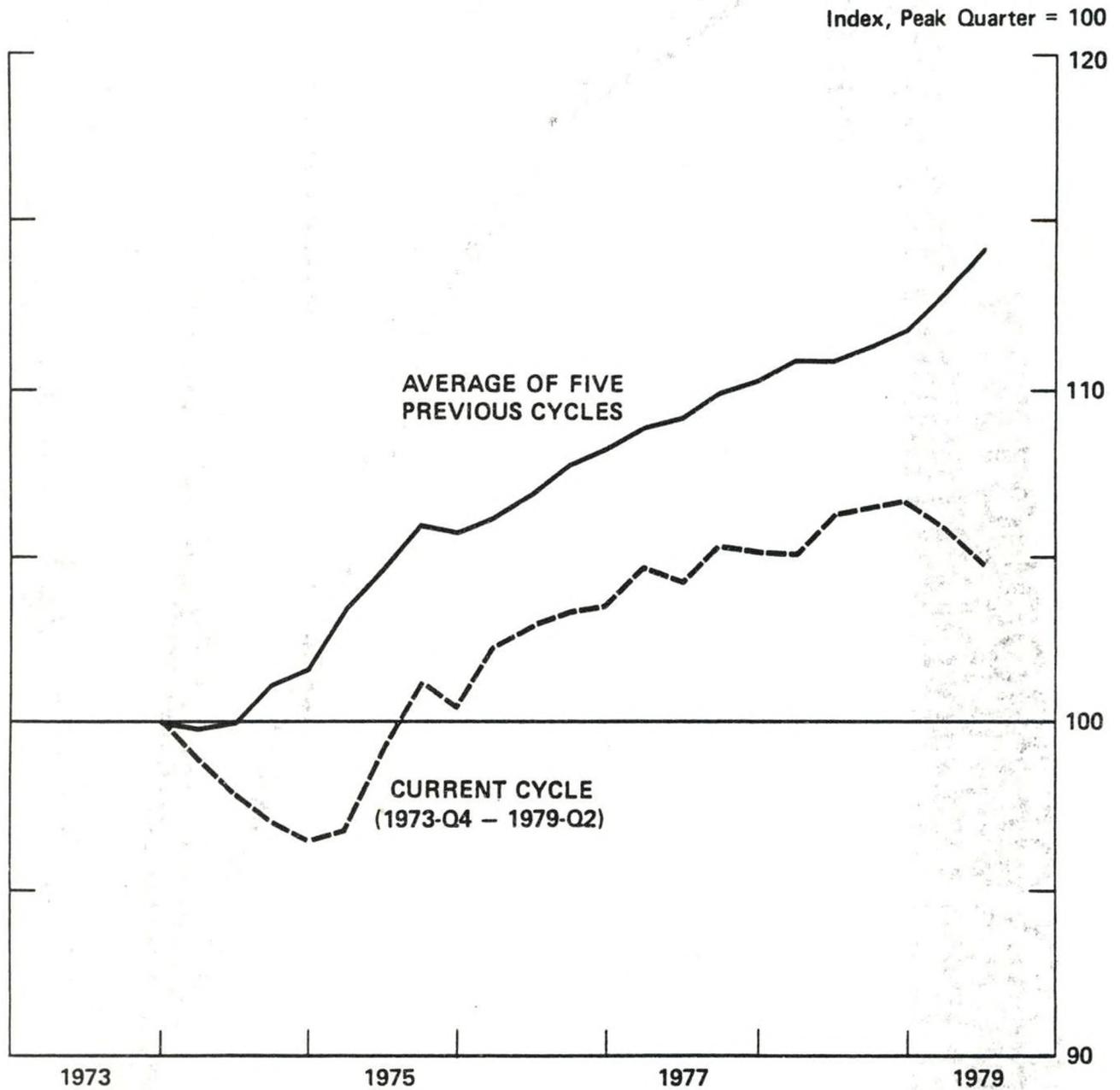


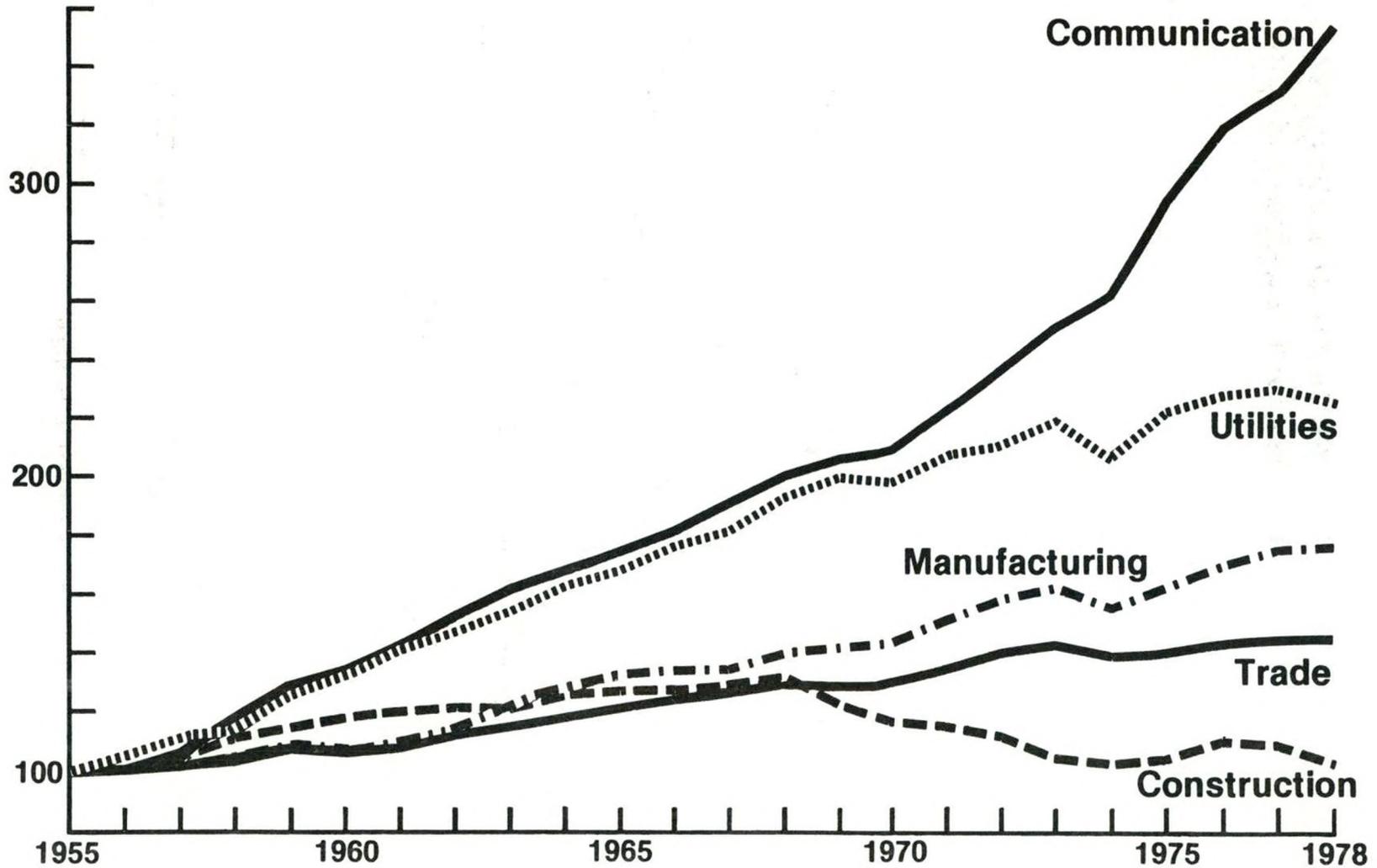
Chart 3

Cyclical Comparisons of Output Per Hour, Private Nonfarm Business Sector*



* Changes following the cyclical peaks as specified by NBER.

INDEX OF PRODUCTIVITY, SELECTED INDUSTRIES (1955=100)



INDEX OF PRODUCTIVITY, SELECTED MANUFACTURING INDUSTRIES (1955=100)

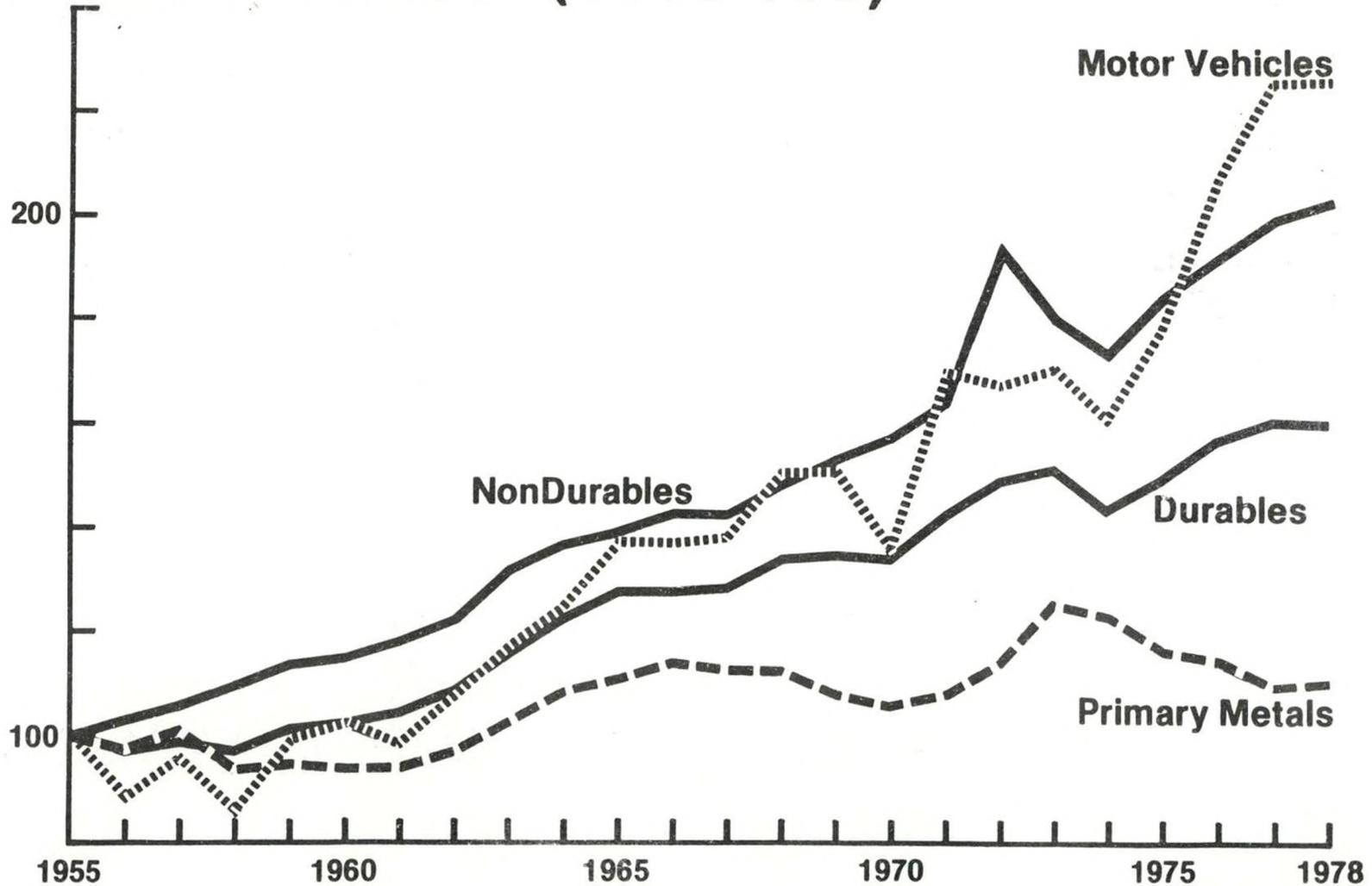


Table 2

**“BEST ALLOWABLE” ADR DEPRECIATION
PERIODS AS COMPARED TO 10-5-3
SELECTED INDUSTRIES**

Asset Class	10-5-3		ADR				
	All Industries	All Industries	Construction	Motor Vehicles	Communication	Primary Metals	Utilities
Autos & Light Trucks	3	3.5	3.8	3.1	4.4	3.2	4.5
Other Machinery and Equipment	5	10.2	5.1	5.8	14.6	11.3	20.4
Buildings	10	32.6	35.0	35.0	36.0	35.0	35.0
Total	5.9	12.7					

Table 3

"Best Allowable" Depreciation Life (Years)
Under Present Law, by Industry

	Cars and Light Trucks	Machinery and Equipment	Building
All Industries	3.5	10.2	32.6
Agriculture	3.9	7.7	20.0
Construction	3.8	5.1	35.0
Oil and Gas			
Drilling	3.2	7.0	35.0
Production	3.2	11.0	35.0
Refining	3.4	12.4	35.0
Marketing	-	13.0	13.0
Mining	3.6	7.8	35.0
Manufacturing			
Food	3.2	9.2	35.0
Tobacco	3.3	11.4	35.0
Textiles	3.2	8.1	35.0
Apparel	3.1	7.1	35.0
Logging/Saw Mills	3.9	6.8	35.0
Wood Products	3.8	7.1	35.0
Pulp and Paper	3.2	9.9	35.0
Printing and publishing	3.1	8.7	35.0
Chemicals	3.1	7.7	35.0
Rubber Products	3.1	9.6	35.0
Plastic Products	3.0	8.0	35.0
Leather	3.0	8.5	35.0
Glass	3.0	9.2	35.0
Cement	3.5	14.0	35.0
Stone and Clay Products	3.5	10.9	35.0
Primary Metal	3.2	11.3	35.0
Fabricated Metal	3.1	4.9	35.0
Machinery	3.0	7.9	35.0
Electrical Machinery	3.0	9.3	35.0
Electronics	3.0	7.1	35.0
Motor Vehicles	3.1	5.8	35.0

"Best Allowable" Depreciation Life (Years)
Under Present Law, by Industry
(continued)

	Cars and Light Trucks	Machinery and Equipment	Buildings
Areospace	3.0	7.8	35.0
Shipbuilding	3.3	9.7	35.0
Railroad Equipment	3.3	8.8	35.0
Instruments	3.1	9.0	35.0
Other	3.1	9.0	35.0
Transportation			
Rail	-	11.7	-
Air	-	9.4	35.0
Water	-	15.7	35.0
Highway	3.4	5.6	35.0
Communication	4.4	14.6	36.0
Utilities			
Electric	4.5	20.5	35.0
Gas	4.5	23.1	35.0
Pipeline	-	17.5	35.0
Wholesale and Retail Trade	3.5	6.8	35.0
Services	3.3	7.8	35.0
Amusements	3.0	9.8	35.0

Note: The "best allowable" depreciation period for an industry is a special type of weighted average of the best available depreciation periods (taking account of the investment credit effects of lives lower than five or seven years) for equipment used in the industry. The weights are estimated 1976 investment in the several types of equipment. The weighted average takes account of the time value of tax saving. In the case of buildings not covered by ADR, the best available depreciation period is assumed to be 35 years, which is approximately the average useful life employed by taxpayers, as revealed by Treasury Department surveys in 1972 and 1973.

TAX SAVINGS DUE TO 10-5-3 PER DOLLAR OF PROJECTED INVESTMENT IN DEPRECIABLE ASSETS ; 1980, 1981, AND 1984, SELECTED INDUSTRIES

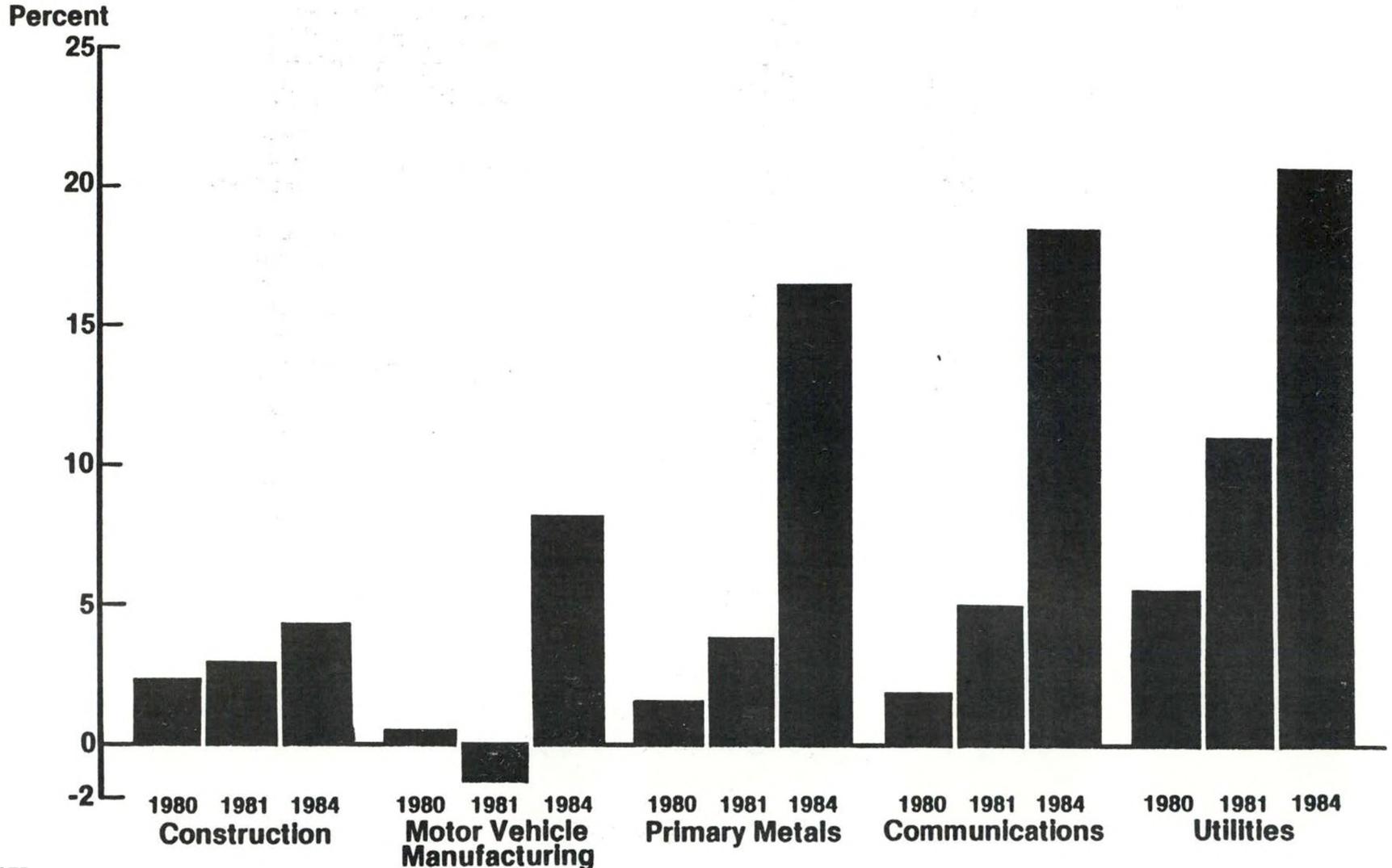


Table 4

Estimated Tax Reduction Due to 10-5-3
as a Percent of Projected Investment 1/, 1984

Industry Class	Estimated 1984 Tax Reduction (\$ Millions)	Projected 1984 Investment (\$ Millions)	1984 Tax Reduction As Percent of Investment
Manufacturing:			
Non-durables	5,729	50,016	11.5
Food	1,258	10,624	11.8
Tobacco	50	369	13.6
Textiles	332	2,757	12.0
Apparel	121	1,196	10.1
Pulp and Paper	837	7,777	10.8
Printing and Publishing	341	3,390	10.1
Chemicals	2,345	19,838	11.8
Rubber	123	927	13.3
Plastics	303	2,918	10.4
Leather	16	220	7.3
Durables			
Durables	5,606	51,496	10.9
Wood Products and Furniture	98	2,100	4.7
Cement	90	622	14.5
Glass	146	1,258	11.6
Other Stone and Clay	281	2,150	13.1
Ferrous Metals	1,107	6,739	16.4
Non-ferrous Metals	421	3,004	14.0
Fabricated Metals	504	6,587	7.7
Machinery	950	8,345	11.4
Electrical Equipment	493	4,448	11.1
Electronics	266	2,884	9.2
Motor Vehicles	458	5,716	8.0
Aerospace	182	1,591	11.4

1/ Estimates of investment by purchasing sector are based on Annual Survey of Manufacturers, 1976, and data from regulatory agencies, trade associations, and other industry sources.

Industry Class	Estimated 1984 (\$Millions)	Projected 1984 (\$Millions)	1984 Tax Reduction As Percent of Investment
Shipbuilding	169	1,534	11.0
Railroad Equipment	17	129	13.2
Instruments	222	2,383	9.3
Other Manufacturing	202	2,006	10.1
Transportation	4,048	40,504	10.0
Railroads	562	3,362	16.7
Airlines	814	6,175	13.2
Water Transport	1,432	9,492	15.1
Highway Transport	1,240	21,475	5.8
Communication	5,956	32,130	18.5
Utilities	9,162	42,187	21.7
Electric Utilities	7,533	35,853	21.0
Gas Utilities and Pipelines	1,629	6,334	25.7
Mining, except oil and gas	1,120	10,796	10.4
Oil and Gas Drilling	238	2,945	8.1
Oil and Gas Production	5,079	38,390	13.2
Petroleum Refining	1,207	8,785	13.7
Petroleum Marketing	142	1,254	11.3
Oil Pipelines	2,202	10,175	21.6
Construction	1,114	25,085	4.4
Wholesale and Retail Trade	3,823	44,097	8.7
Agriculture	2,069	27,220	7.6
Services	3,337	41,109	8.1
Grand Total	51,912	435,725	11.9

BENEFITS OF 10-5-3 AS COMPARED TO RECENT GROWTH IN PRODUCTIVITY, SELECTED INDUSTRIES

1984 Tax Saving as
Percent of Investment

Average Annual Productivity
Growth, 1973-78

