- Businesses are encouraged to use debt financing because interest payments that are increased because of inflation are deductible while increases in stock dividends are not; and

- After-tax returns on plant and equipment tend to decline relative to other assets, such as owner-occupied housing, because depreciation is understated.

Unanticipated inflation provides a gain to borrowers and a loss to creditors. But to the extent that inflation is anticipated, its effects tend to become incorporated in higher nominal interest rates. In principle, interest rates could adjust to take into account both inflation and the tax treatment of interest. For example, if inflation is at a 10 percent rate and the marginal tax rate on borrowers and lenders is 40 percent, interest rates would need to increase by 16.7 percentage points for lenders and borrowers to be in the same after-tax situation. Available research indicates that interest rates have tended to increase approximately point for point with inflation--but not enough to compensate lenders for the taxation of nominal interest. 6/ The increase in interest rates in the last year may, however, have incorporated both expected inflation and the tax treatment of interest.

Differences of opinion about the after-tax profitability of capital are concerned primarily with whether to include the gain to debtors from unanticipated inflation, which enables them to repay loans with depreciated dollars. To do so would reduce the estimated tax rate on the income from capital. Consequently, some investigators argue that the appropriate measure of after-tax corporate profits should include the impact of inflation on corporate balance sheets, especially the decline in the real value of corporate debt resulting from inflation. Using that approach, the profit rate after income taxes was not lower in the 1970s compared with most of the postwar period, although it was lower than during

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6/ Vito Tanzi, "Inflationary Expectations, Economic Activity, Taxes and Interest Rates," American Economic Review (March 1980), pp. 12-21; and Martin Feldstein and Lawrence Summers, "Inflation, Tax Rules, and the Long-Term Interest Rate," Brookings Papers on Economic Activity, 1978:1, pp. 61-99.

the mid-1960s. 7/ Much of the gain to debtors during this period was, however, a once-over gain associated with the (unexpected) increase in inflation.

Other investigators believe that in assessing the profitability of capital the after-tax return to all investors in the business sector should be the focus--including the after-tax return to shareholders and creditors. This perspective encompasses the tax burden of the owners of corporate shares and debt instruments, including federal, state, and local taxes. Viewed in this way, the tax rate on income from capital was comparatively high during the 1950s, declined during the early and mid-1960s, and then increased until the mid-1970s. 8/ It should be noted that, as indicated in Table 27, the before-tax return on capital was also comparatively low during the 1970s.

Another approach to the same problem is to focus on the "cost of capital," which includes economic depreciation and the cost of funds, in addition to tax considerations. It appears that, on balance, fully anticipated inflation tends to increase the cost of capital and to lower the return on capital. That is, losses due to historical depreciation tend to outweigh the gain from being

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7/ Burton G. Malkiel and George M. von Furstenberg, "Financial Analysis in An Inflationary Environment," Journal of Finance (May 1977), pp. 575-92; and John B. Shoven, "Inflation and Income Taxation," in Michael J. Boskin, ed., Federal Tax Reform: Myths and Realities (Institute for Contemporary Studies, 1978), pp. 171-88.

8/ Martin Feldstein and Lawrence Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector," National Tax Journal (December 1979), pp. 445-70. Some of the assumptions made in this paper have been challenged by another researcher, Jane Gravelle, who obtained a lower estimate of the recent tax burden. By her calculations, the federal tax burden did not increase in the late 1970s because of legislated tax reductions. Nevertheless, her data suggest that when state and local taxes are included, the total tax burden did increase. See Jane Gravelle, "Inflation and the Taxation of Capital Income in the Corporate Sector: A Comment," Congressional Research Service, The Library of Congress (Processed, 1981).

able to deduct nominal interest costs, when inflation becomes fully anticipated. 9/

Despite disagreements as to the correct measure of profits, the evidence suggests that the overall return on business capital (economic profits plus interest) was substantially lower during the 1970s than in the earlier postwar period. 10/

Profits by Industry and Sector

The distribution of profits by industry and sector of the economy for the period 1950-1979 is shown in Table 28. Several trends are evident:

- A decline in the profit share of durable goods manufacturing;
- A decline in the share of profits in the regulated sector;
- An increase in the share of profits of American business abroad, especially in the last few years;
- An increase in the share of profits in the energy sector; and
- An increase in Federal Reserve "profits." 11/

9/ Martin Feldstein, "Inflation, Capital Taxation and Monetary Policy," presented to the National Bureau of Economic Research Conference on Inflation, Washington, D.C., October 10, 1980.

10/ The "correct" measure of profits depends in large part on the purpose at hand. The purpose of this chapter is to consider whether the return on capital is sufficient to attract high levels of investment. For this particular purpose, the overall return on capital to stockholders and creditors seems the most appropriate measure. The historical return to stockholders exaggerates the return to capital by including the gains to borrowers from inflation (particularly from unanticipated inflation), but not the losses incurred by lenders.

11/ The net income of the Federal Reserve is treated as corporate profits in the National Income Accounts.

TABLE 28. PERCENTAGE DISTRIBUTION OF CORPORATE PROFITS WITH INVENTORY VALUATION ADJUSTMENT, ALL INDUSTRIES

	1950 to 1959	1960 to 1969	1970 to 1979
Total Before-Tax Profits with Inventory Valuation Adjustment	100.0	100.0	100.0
Domestic Industries	94.9	93.8	89.0
Financial	10.8	12.2	14.6
Federal Reserve	1.0	2.2	4.4
Other	9.8	10.0	10.2
Nonfinancial	84.1	81.6	74.4
Manufacturing	52.8	48.6	42.4
Nondurables	24.5	22.4	23.3
Food	4.2	4.1	3.9
Chemicals	6.0	6.0	5.1
Petroleum	6.1	4.2	6.6
Other	8.2	8.1	7.6
Durables	28.2	26.2	19.1
Primary Metals	5.6	3.3	1.9
Fabricated Metals	2.5	2.4	2.2
Nonelectrical Machinery	4.4	4.6	4.1
Electrical Machinery	3.1	3.0	2.3
Motor Vehicles	5.8	6.6	3.8
Other	6.8	6.4	4.8
Wholesale and Retail Trade	10.8	10.9	13.9
Regulated Industries	12.3	14.5	9.3
Other Nonfinancial	8.3	7.6	8.8
Rest of the World	5.0	6.2	11.0

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

A similar picture emerges when profits are measured against the gross product in each industry: The profit share has fallen markedly in durable goods manufacturing, notably in the industries that include autos and steel, and increased in petroleum manufacturing (see Tables 29 and 30).

TABLE 29. SHARE OF GROSS PRODUCT NOT DEVOTED TO EMPLOYEE COMPENSATION, BY MAJOR SECTORS

	1950 to 1959	1960 to 1969	1970 to 1978
Agriculture, Forestries, Fisheries	84.6	81.2	82.0
Mining	63.3	64.3	62.6
Construction	29.3	26.2	24.6
Manufacturing	32.8	31.9	28.4
Nondurables	37.2	36.9	35.1
Durables	29.4	28.4	23.8
Transportation	32.0	31.5	29.0
Communication	46.6	54.8	49.6
Electric, Gas, Sanitation	63.3	68.1	66.9
Wholesale Trade	46.6	45.6	45.9
Retail Trade	44.7	40.6	39.0
Finance, Insurance, Real Estate	80.8	80.0	77.0
Services	39.0	36.4	30.0
Total	43.0	41.3	38.5

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Causes of the Decline in Profitability

The decline in the return on capital has not been limited to the United States, but seems to have occurred in all or most industrial countries. 12/ In the United States, as noted above, the decline in profits has been especially severe in regulated industries and in certain durable goods manufacturing industries, such as autos and steel. Aside from the effects of taxes, several

12/ T.P. Hill, Profits and Rates of Return, OECD (1979), pp. 113-31.

TABLE 30. SHARE OF GROSS PRODUCT NOT DEVOTED TO EMPLOYEE COMPENSATION, MANUFACTURING INDUSTRIES

	1950 to 1959	1960 to 1969	1970 to 1978
Food and Kindred Products	42.8	41.5	39.7
Tobacco Manufactures	86.0	84.9	80.8
Textile Mill Products	20.3	24.7	21.5
Apparel and Other Textile Products	13.8	13.4	14.0
Lumber and Wood Products	30.6	32.0	38.3
Furniture and Fixtures	20.1	20.1	15.6
Paper and Allied Products	39.4	33.5	31.9
Printing and Publishing	23.2	23.7	24.4
Chemicals and Allied Products	47.3	44.2	39.2
Petroleum and Coal Products	45.3	57.9	62.6
Rubber and Miscellaneous Plastics	30.7	29.6	25.7
Leather and Leather Products	14.3	14.1	12.5
Stone, Glass, and Clay Products	34.6	30.7	25.0
Primary Metals	34.8	31.4	24.4
Fabricated Metals	21.4	20.8	20.6
Nonelectrical Machinery	27.5	26.6	23.3
Electrical Machinery	26.5	22.6	22.2
Motor Vehicles and Equipment	46.2	51.7	34.8
Other Transportation Equipment	15.2	12.7	5.9
Instruments and Related Products	21.8	27.0	19.5
Misc. Manufacturing Industries	25.2	23.0	25.5
Total Manufacturing	32.8	31.9	28.4

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

factors may have contributed to the decline in the after-tax return on capital in the United States. 13/ Among them are:

13/ Nordhaus, writing in the mid-1970s, attributed the decline in the profit rate that began after about 1965 to a reduction in the cost of capital caused by a lessened perception of risk and tax reductions in the 1960s. According to this analysis the lower cost of capital contributed to a rapid growth in the

- Continued gains in real wages that exceeded productivity growth in the economy;

- Other increases in costs such as higher energy costs and the costs of complying with government regulations;

- Intensified foreign competition; and

- Persistent economic slack, which especially affects cyclical industries in durable goods manufacturing.

Wages. There is little evidence to suggest that real wage gains in the aggregate have been "excessive," in the sense of squeezing profits. But labor cost data suggest that an important dichotomy has developed in the labor market between high-wage industries and lower-wage industries. In the high-wage industries, labor compensation per hour, in real terms, has continued to increase at about the same rate throughout the postwar period. In the lower-wage industries, there has been a marked slowing in line with the slowdown in productivity growth (see Table 31). Specifically, workers in high-wage industries such as automobiles, primary metals, rubber, petroleum, transportation, and utilities have generally received significantly higher rates of wage increase than workers in lower-wage industries. One reason is that the former have been able to adjust their pay to keep up with rising consumer prices, thus maintaining their accustomed growth in real incomes. By contrast, workers in lower-wage industries have been unable to keep up with inflation. 14/

13/ (Continued)

stock of capital which, in turn, depressed the return on capital. See William D. Nordhaus, "The Falling Share of Profits," Brookings Papers on Economic Activity, 1974:1, pp. 169-208. More recently, Jeffrey Sachs has emphasized institutional factors, particularly the behavior of unions. See Jeffrey D. Sachs, "Wages, Profits, and Macroeconomic Adjustment: A Comparative Study," Brookings Papers on Economic Activity, 1979:2, pp. 269-319.

14/ For a more detailed discussion, see CBO, Inflation and Growth: The Economic Policy Dilemma (July 1978), pp. 35-40. CBO's analysis indicates that percentage wage gains have been larger in large establishments and among unionized workers.

TABLE 31. ANNUAL GROWTH RATES IN REAL COMPENSATION PER EMPLOYEE HOUR IN MANUFACTURING INDUSTRIES

	1950 to 1965	1965 to 1973	1973 to 1978
Food and Kindred Products	2.7	2.3	2.2
Tobacco Manufactures	3.7	3.9	5.3
Textile Mill Products	1.3	2.3	1.4
Apparel and Other Textile Products	1.0	1.9	0.4
Lumber and Wood Products	2.4	3.3	2.8
Furniture and Fixtures	1.9	2.0	0.7
Paper and Allied Products	2.7	2.7	2.9
Printing and Publishing	1.8	1.8	0.3
Chemicals and Allied Products	2.9	2.3	2.2
Petroleum and Coal Products	2.9	1.1	3.0
Rubber and Miscellaneous Plastics	2.1	1.5	1.6
Leather and Leather Products	1.6	1.5	0.9
Stone, Glass, and Clay Products	2.7	2.7	2.1
Primary Metals	2.9	2.8	4.0
Fabricated Metals	2.4	2.0	2.2
Nonelectrical Machinery	2.7	2.1	2.0
Electrical Machinery	2.8	1.9	1.8
Motor Vehicles and Equipment	3.2	3.5	3.2
Other Transportation Equipment	3.5	2.2	1.6
Instruments and Related Products	2.8	1.7	1.1
Misc. Manufacturing Industries	2.1	2.2	0.6
Total Manufacturing	2.7	2.3	2.2

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Many high-wage workers may not be aware of their success in keeping up with inflation. They may feel that their pay has increased very little, or declined, even though their employers have experienced rising labor costs. One reason for this difference in perception is that growth in compensation per hour (employers' labor cost) has far outstripped gains in wages and salaries per hour. The difference between compensation and pay includes employers' payroll taxes plus fringe benefits such as the

employers' share of health and pension benefits. 15/ Government policies have contributed to the rapid growth in these labor costs. Not only have government policies led to increases in payroll taxes. In addition, the tax system encourages a shift in compensation toward a greater emphasis on fringe benefits to the extent that they are deductible for employers and nontaxable or taxable at reduced rates for employees.

The momentum of real wage gains in high-wage industries in the face of reduced productivity growth and declining profit rates has had at least two consequences. First, it has tended to reduce the competitiveness of some U.S. industries in international markets. This, in turn, has contributed to pressure on the Congress to limit foreign competition across a broad range of products including steel, autos, textiles, shoes, and television sets--to name only a few of the more important ones. 16/

Second, the momentum in real wages may have contributed to productivity slowdown in two ways: first, by shifting employment from high-productivity sectors such as durable goods manufacturing to lower-productivity sectors such as services, and second, by squeezing profits and thereby slowing the modernization of plant and equipment.

Energy. Sharp increases in energy costs may also have contributed to the decline in the return on capital. The jump in

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15/ Payroll taxes and fringe benefits grew from an average of 8.6 percent of manufacturers' total labor compensation cost in the 1950-1965 period to 12.6 percent in 1966-1973, and to 16.8 percent in 1974-1978. The share of such benefits was highest in several of the highest-paid industries, suggesting that as workers reach higher tax brackets the compensation package shifts in favor of pension and other "fringe benefits" that receive preferential treatment in the federal income tax system. The cost of medical care--an important component of employers' labor costs--has also increased rapidly since the mid-1960s.

16/ To be sure, other factors besides wage momentum have played important roles in the declining international competitiveness of U.S. basic industries. For one thing, industrial capacity has grown rapidly in such countries as Mexico, South Korea, Brazil, and Hong Kong.

energy costs caused some capital to become prematurely obsolete. Rising energy costs also caused consumers to shift their purchases away from energy-intensive products.

Government Regulations. Business firms have had to devote substantial capital investment to meeting social objectives such as cleaner air and water. Such investments may yield significant returns to society, but they bring little or no financial return to private investors.

Economic Slack. Substantial economic slack also tended to depress the return on capital during the 1970s. Historically, corporate profits have been very sensitive to overall business conditions. The recession of 1974-1975 was the most severe of the postwar period. In addition, there were relatively few years during the decade when measures of capacity utilization were at high levels.

CAPITAL ACCUMULATION, INNOVATION, AND PRODUCTIVITY GROWTH

The decline in profitability appears to be a major reason for declining productivity growth in recent years. It has had a damping effect on the accumulation of capital and on innovation--two major determinants of productivity growth. An increase in the amount of physical capital--such as tools, machinery, and other work-facilitating equipment--per worker is associated with an increase in output per hour worked. Also important in determining productivity are the quality and composition of the capital stock--that is, the degree to which the capital stock embodies the best technology and is allocated to its most productive uses. Finally, innovation, or the development and spread of new products and new techniques of production, is believed to be crucial to the process of productivity growth.

Physical Capital Formation. The relationship between capital investment, or capital formation, and gains in productivity has been the subject of considerable study. Estimates differ as to the contribution made by capital to productivity growth, but all investigators give it a significant role. 17/ It is also apparent

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17/ For a more detailed discussion, see CBO, The Productivity Problem: Alternatives for Action (January 1981), pp. 29-35.

that the estimated contribution of capital has declined substantially in recent years, although there is some disagreement about the extent of the decline and when it began.

The slowdown in the growth of capital per worker is illustrated by the data in Table 32. Over the most recent period, 1974-1979, the net capital stock grew 3.0 percent per year, compared with 4.0 percent or more in earlier postwar periods. At the same time, employment and hours accelerated in the 1974-1979 period so that the capital/labor ratio was about unchanged. In earlier periods, the capital/labor ratio grew roughly 3 percent per year. Moreover, in the recent decade a larger share of capital spending was devoted to meeting government regulations (such as for pollution abatement and occupational health and safety) and energy efficiency. Also, the run-up in energy prices is believed to have rendered a substantial part of the capital stock economically obsolete. As a result, the estimates of the net capital stock understate the extent of the slowdown in productivity-enhancing capital accumulation. 18/

Real business fixed investment in relation to real gross national product (GNP) was historically relatively high in the 1974 to 1979 period, while the growth rate in the net capital stock was not. 19/ There are two reasons for this: First, real GNP grew more slowly from 1974 to 1979, compared with its longer-run growth rate in earlier periods. Second, depreciation made up a larger share of gross investment in recent years, partly because the mix of capital shifted toward shorter-lived equipment and away from longer-lived structures. Therefore, to restore the growth rate in the net capital stock or in the capital/labor ratio would require

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18/ The contribution of capital formation to productivity growth is generally calculated as the percentage change in the capital-labor ratio weighted by the share of output or income attributable to capital. Quantitative estimates of the contribution can differ because of alternative approaches to the measurement of capital, labor, and output.

19/ The data in Table 32 reflect the recent revisions by the Commerce Department in the National Income Accounts. Those revisions substantially raised the estimates of business fixed investment and of saving, but they did not alter the fundamental conclusion reached by researchers that a slowdown in capital accumulation and a decline in saving rates occurred.

TABLE 32. THE INVESTMENT SHARE AND GROWTH IN THE CAPITAL-LABOR RATIO

Period	Real Business Fixed Investment as a Percent of Real GNP (annual average)	Percent Change, Annual Rate (end of year to end of year)				
		Net Capital Stock a/	Employment b/	Hours b/	Capital-employment ratio	Capital-hours ratio
1949 to 1959	9.1	4.0	1.1	0.7	2.9	3.2
1959 to 1969	9.8	4.6	1.6	1.2	3.0	3.3
1969 to 1974	10.5	4.2	1.2	0.5	2.9	3.7
1974 to 1979	10.3	3.0	3.1	2.8	-.1	0.2

a/ Net fixed nonresidential business capital, 1972 dollars, end of year.

b/ For private business, all persons. End of year calculated as average of year's fourth quarter and of following year's first quarter.

SOURCE: Economic Report of the President, January 1981, p. 71.

TABLE 33. GROWTH IN REAL SPENDING FOR RESEARCH AND DEVELOPMENT BY SOURCE OF FUNDS (Annual percentage growth in 1972 dollars)

Period	Total R&D	Private Industry R&D	Federal Government R&D
1953-1965	9.9	7.2	11.7
1965-1973	1.0	4.5	-1.5
1973-1978	1.8	3.3	0.4
1978-1979	3.4 a/	4.5 a/	2.3 a/

a/ Preliminary.

SOURCE: National Science Foundation, National Patterns of Science and Technology Resources 1980, NSF 80-308 (1980), Table 5.

an even higher ratio of business fixed investment to GNP than during the 1974-1979 period (or a faster rate of growth in GNP if the ratio of investment to real GNP does not increase).

Innovation. The rate of innovation is difficult to measure, but some indicators, such as investment in research and development, and the number of patents granted, indicate that it has been slowing (see Table 33). Also, the spread of new technology is intimately tied to the pace of capital accumulation.

Concern about lagging productivity growth has given rise to many proposals for stimulating business investment and innovation. Several of these are discussed in the following pages. 20/

POLICY STRATEGIES TO STIMULATE INVESTMENT

The review of profit behavior in this chapter suggests that one way to increase profits and investment would be through the

20/ For a more detailed discussion, see CBO, The Productivity Problem: Alternatives for Action (January 1981), chapters 2, 3, 5, and 8.

use of stimulative monetary and fiscal policies. Indeed, some economists argue that this would be the most effective way to stimulate investment given the current low levels of capacity utilization. But stimulative policies would add to the present high rate of inflation. Therefore, this section explores several alternatives.

Tax Incentives for Business Investment

Business tax cuts would help to raise the after-tax return on investment and innovation, thereby stimulating economic growth. Investment incentives, such as more rapid depreciation, increases in the investment tax credit, and tax credits for increases in research and development, probably would be more effective per dollar of tax reduction than would reductions in the corporate income tax rate. To be most effective, such incentives should not interfere with a major function of profits--allocating investment to its more productive uses.

The Accelerated Cost Recovery System. The Administration's business tax proposal calls for increasing the write-off of capital expenditures, and for a simplified depreciation system. Under the proposal, which is a modification of the 10-5-3 proposal introduced in the last Congress (H.R. 4646), equipment could be written off in either three years (autos, light trucks, and equipment used for research and development) or five years (other types of machinery and equipment). Certain classes of structures, such as factory buildings, retail stores, and warehouses used by owners, would qualify for 10-year depreciation levels, while other nonresidential structures would be assigned 15-year lives. Residential structures would be depreciated over 18 years. In addition, the proposal would also liberalize the investment tax credit by allowing 6 percent on three-year equipment and the full 10 percent for five-year equipment. 21/

21/ Currently, equipment with useful lives of at least seven years is eligible for a 10 percent credit, while equipment with useful lives of at least five but less than seven years is limited to a 6-2/3 percent credit, and equipment with useful lives of three to five years is restricted to a 3-1/3 percent credit. Shorter-lived equipment is not eligible for a credit.

The investment proposals would be effective retroactively to January 1, 1981. The 5-, 10-, and 15-year depreciation categories would be phased in over a five-year period. 22/

The static revenue losses from the Administration's business tax cut proposals (without feedback effects from the economy) are estimated by CBO to increase from $2.5 billion in fiscal 1981 to $40.5 billion in fiscal 1985.

From an economic standpoint, the Administration's business tax cut proposal raises at least two issues. First, it would sever to a substantial degree any connection between the tax life of an asset and its actual economic or productive life. Proponents of this type of change argue that not much is known about the actual economic lives of assets anyway. On the other hand, opponents argue that such a departure would seriously distort investment decisions. 23/ For example, it could result in actual tax subsidies (negative taxes) on the income from some kinds of capital, and thus affect the allocation of resources among different kinds of investment.

A second issue is whether the announcement of a schedule for future reductions in depreciation lives would cause businesses to postpone investments to a substantial extent. The phasing-in would limit the revenue loss in early years. But knowledge that more liberal treatment of depreciation would be available in later years could cause postponement of some investment projects.

The Simplified Cost Recovery System. Another proposal to reduce the impact of inflation on capital cost recovery by increasing the size of depreciation deductions is the Senate Finance

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22/ For a more detailed description of the Administration's Accelerated Cost Recovery System, see American's New Beginning: A Program for Economic Recovery, The White House (February 18, 1981), Part IV, pp. 26-40.

23/ See, for example, Alan J. Auerbach and Dale W. Jorgenson, "The First Year Capital Recovery System," prepared for hearings of the Ways and Means Committee, U.S. House of Representatives, November 14, 1979.

Committee's Tax Reduction Act of 1980. 24/ Under that proposal, known as the Simplified Cost Recovery System, equipment investment would be assigned to one of four depreciation categories corresponding to useful lives of two, four, seven, and ten years. Owner-occupied commercial and industrial buildings could be depreciated over a 15-year period, and most other types of structures over a 20-year period. Most property now eligible for the Accelerated Depreciation Range (ADR) system would be assigned to a useful life category that is at least 40 percent shorter, except that no recovery period would be shorter than two years. In addition, the bill would modify the investment tax credit. A 2-1/2 percent credit would be provided for the two-year class, a 6 percent credit for the four-year class, and a 10 percent credit for both the seven-year and the ten-year classes. CBO estimates that the static loss in federal receipts would increase from $4.3 billion in fiscal 1981 to $19.7 billion in fiscal 1985, under this proposal.

In an effort to measure the economic impact of the Senate Finance Committee's proposal, CBO applied it to three large-scale econometric models in 1980 (see Table 34). The wide disparity in results indicates the uncertainty attached to such estimates. However, they do give a rough indication of possible effects. The level of productivity averaged from 0.3 to 0.6 percent higher from 1981 to 1985, compared with the baseline. 25/ Estimates by CBO suggest that the depreciation proposal would increase after-tax corporate profits as a share of national income by approximately 0.9 percentage point by 1985. The measure would thus partially restore the after-tax profit share and return on capital to pre-1970 levels.

Limitations of Depreciation Proposals. Liberalizing depreciation rules, taken by itself, has several limitations. First, unless depreciation rates are tied to prices (either by an index or through a measure such as the First Year Capital Recovery System), the effect on incentives to invest would remain sensitive

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24/ This bill was introduced as H.R. 5829. Its approach also resembles that of H.R. 4646.

25/ For a more detailed discussion, see The Productivity Problem, pp. 36-43. In each simulation, monetary policy was assumed to be conducted in a manner that held nonborrowed reserves constant, thus allowing interest rates to change.

TABLE 34. IMPACTS OF THE SIMPLIFIED COST RECOVERY SYSTEM, 1981 TO 1985: ESTIMATES FROM THREE ECONOMETRIC MODELS (Average annual change)

Area of Impact	Range of Three Models a/
Business Fixed Investment (increase in billions of 1972 dollars)	2.7 to 11.5
Level of Real GNP (percent change from baseline)	0.5 to 0.8
Level of Productivity (percent change from baseline)	0.3 to 0.6

a/ The three econometric models are Data Resources, Inc., Chase Econometrics, Inc., and Wharton Econometric Forecasting Associates, Inc.

SOURCE: Congressional Budget Office.

to the rate of inflation. Second, liberalizing depreciation would not alter current features of the tax system that favor borrowers over lenders and that encourage businesses to become more highly leveraged with debt. Third, it would not deal with the particular problems of such basic industries as autos, steel, and rubber--industries that were once the industrial backbone of America.

Structural Policies

Other policies that have been proposed to restore prosperity to U.S. basic industries include:

- Import restrictions;
- Incomes policies; and
- Adjustment assistance.

Import Restrictions. Restrictions on imports might help to shore up industries that are faced with strong foreign competition in domestic markets. Such restrictions would entail heavy costs. They would invite other countries to retaliate against U.S. exports that are currently highly competitive abroad. Such restrictions would require U.S. consumers to pay more for the protected goods. And they would tend to encourage the continuation of inflationary wage settlements in the protected industries, weakening the discipline of the marketplace that could eventually provide a brake on inflationary settlements.

Incomes Policies. The government might undertake to encourage (or coerce) a less inflationary pattern of wage and price determination in basic industries. Incomes policies have been tried both in the United States and in other countries, but without notable success, particularly over extended periods. A recent proposal has been to tie wage settlements to the income tax, offering tax reductions as an incentive to wage and price restraint. 26/

Adjustment Assistance. Public policies can, in principle, help to facilitate the adjustment of labor and capital. For example, government-subsidized loans can encourage investment in declining or economically depressed areas. Employment policies can emphasize retraining workers as opposed to simply providing unemployment insurance benefits for those displaced by import competition and other basic economic changes. On the other hand, such policies can have adverse effects on the working of the markets for labor and capital. It is the marketplace that ultimately guides business and labor in their economic decisions. 27/

26/ For background discussions of incomes policies as an approach to reducing inflation, see the following CBO reports: Incomes Policies in the United States: Historical Review and Some Issues (May 1977); Inflation and Growth: The Economic Policy Dilemma (July 1978), p. 63; and The Fiscal Policy Response to Inflation (January 1979), Appendix A.

27/ For a more detailed discussion of "industry policies," see CBO, The Productivity Problem, (January 1981), Chapter 8.