Luis, Juan

THE WHITE HOUSE

WASHINGTON

February 1, 1982

Dear Governor Luis:

I appreciate you forwarding me a copy of the position paper, "Caribbean Basin Initiative Proposals of the United States Virgin Islands."

I will read the paper with interest, and am confident the views of the U.S. Virgin Islands will be fully considered in the formulation of the Caribbean Basin Initiative proposal.

Sincerely,

James W. Cicconi

James W. Cicconi
Special Assistant to the President

The Honorable Juan Luis
Governor
The Virgin Islands of the United States
Charlotte Amalie, St. Thomas 00801

THE VIRGIN ISLANDS OF THE UNITED STATES
OFFICE OF THE GOVERNOR
CHARLOTTE AMALIE, ST. THOMAS 00801

January 5, 1982

Hon. James Cicconi
Special Assistant to the President
The White House
Washington, D.C. 20500

Dear Mr. Cicconi:

Enclosed for your information and review is a copy of a position paper entitled "Caribbean Basin Initiative Proposals of the United States Virgin Islands" which details specific policies which the U.S. Virgin Islands believes should be included in the administration's Caribbean Basin Initiative. The paper was submitted to U.S. Trade Representative William Brock on December 31.

I hope you will take the views of the U.S. Virgin Islands into consideration when formulating policy toward the Caribbean region.

Sincerely yours,

Juan Luis

JUAN LUIS
Governor

THE VIRGIN ISLANDS OF THE UNITED STATES
OFFICE OF THE GOVERNOR
CHARLOTTE AMALIE, ST. THOMAS 00801

December 31, 1981

Honorable William Brock
United States Trade Representative
600 17th Street, N.W.
Wasington, D.C.

Dear Ambassador Brock:

Enclosed is a position paper entitled "Caribbean Basin Initiative Proposals of the United States Virgin Islands" which details specific policies which the U.S. Virgin Islands believes should be included in the administration's Caribbean Basin Initiative. Many of them were mentioned in our earlier background paper which we discussed during our meeting in Washington last month.

During the ensuing weeks, the local task force which I appointed has been working to further develop these proposals and has consulted with your staff, with the Departments of Interior and State, and with the Commonwealth of Puerto Rico.

Our goal has been to fashion a program which will maintain and improve the ability of the U.S. Virgin Islands to develop its economy and continue to serve as an example to other countries in the region of the political, social, and economic advantages that a democratic system can provide. In developing our proposals we have also attempted to provide new means by which the United States can help its own territories first as it begins to extend to other Caribbean countries some of the tax and trade concessions, and other advantages which are currently available only to the U.S. Virgin Islands and Puerto Rico.

Our proposals include return to the Territory, for use in capital construction projects, of federal excise taxes on all products (including petroleum products) which are manufactured in the Virgin Islands; funding of the final phases of the St. Thomas airport construction project and funding of the St. Croix airport expansion to help our tourism-based economy; support in Congress for the Territory's proposal to reduce the 30% tax on passive income to help stimulate investment; an increase in the percentage of foreign materials which may be contained in products manufactured in the Virgin Islands for duty-free import into the United States; establishment of low interest funding sources through a United States Territorial development bank to stimulate further development of new and existing businesses; financing assistance for electric generating and water production, distribution, and storage facilities; as well as certain trade and tax concessions to improve our attractiveness as a tourist destination and to revive our suffering watch industry.

The U.S. Virgin Islands wants to continue in its role as a full partner in the development of the administration's new emphasis on our politically and strategically vital part of the world. We believe that inclusion in the Caribbean Basin Initiative of the proposals contained in the paper is a vital step in our mutual efforts to gain new strength and prosperity in the region. We stand ready to work with you further on development and implementation of the Caribbean Basin Initiative.

Sincerely yours,

Juan Luis

JUAN LUIS
Governor

CARIBBEAN BASIN INITIATIVE

PROPOSALS OF THE UNITED STATES

VIRGIN ISLANDS

U.S. Virgin Islands Task Force On

The Caribbean Basin Initiative

December 30, 1981

INTRODUCTION

In a background paper submitted to the Office of the U.S. Trade Representative on November 16, 1981, the U.S. Virgin Islands presented information on how various U.S. trade and economic policies being considered for countries in the Caribbean area might effect the Territory. The paper also included an historical and economic perspective of the special tax and trade concessions which have long been the basis for U.S. policy toward its territories. As expressed in the paper, the Territory's position is based on the concept that:

> ".. the program developed by the federal government should benefit both the U.S. Virgin Islands and the Caribbean nations. We seek to insure that the value of special treatment currently available to U.S. citizens and businesses in the U. S. Virgin Islands is not reduced or eliminated by the granting of similar concessions to foreign nations without a compensatory programs designed to maintain the growth and development of the U.S. Virgin Islands' economy."

We, the members of Governor Juan Luis' Task Force, composed of representatives of the U.S. Virgin Islands public and private sectors, have continued to analyze and refine the policy suggestions contained in our earlier paper and in doing so have consulted with representatives of the Commonwealth of Puerto Rico and of the U. S. Departments of

Interior and State and the office of the U. S. Trade Representative. While we have received verbal assurances that the U. S. Virgin Islands will not be injured by the Caribbean Basin Initiative, we have yet to receive any formal response from the federal government as to how we will be protected or as to whether any or all of our compensatory proposals will be included in the final draft of the Initiative. Furthermore, we are not aware of the extent to which the federal government may have analyzed these compensatory proposals to determine whether they will truly offset the damage to our economy which would result by extending trade and tax concessions, developed for U.S. territories over many years,to foreign nations not operating under U.S. labor, health, safety and environmental laws. We urge that compensatory programs be developed before the Caribbean Basin Initiative is finalized to adequately offset such economic damage to the United States Caribbean possessions.

The proposals primarily emphasize the development and maintenance of the infrastructure needed to support the further economic development of our insular communities and other means by which to stimulate the new investment and new jobs which will make our economy stronger and ultimately less reliant on direct federal aid, as well as, hopefully, more competitive with foreign nations, including those surrounding us in the Caribbean Basin.

We firmly believe that inclusion of our proposals in the Caribbean Basin Initiative and their implementation through a combination of federal and local action will advance the goals of the United State in the region. We stand ready to work on the legislation and implementation stages of the Initiative and to further refine and support our proposals as the process moves forward.

1. Rum Production and Revenues:

The Administration is considering reduction or complete elimination of U.S. tariffs on foreign rum as part of a one-way free trade zone with Caribbean nations. These tariffs provide protection to U.S. Virgin Islands rum producers which serve to offset the higher operating costs associated with manufacturing pursuant to U.S. labor and environmental laws. The U.S. Virgin Islands is unalterably opposed to elimination or further reduction of these tariffs, as such action would result in the eventual destruction of our rum industry, which provides the local government with a major revenue source in the form of excise taxes currently valued at $37.3 million annually, as well as 100 jobs, and the additional government revenues resulting from this economic activity.

If U. S. tariffs on rum were reduced or eliminated ,spirits manufacturers including those already located in the territory would be encouraged to shift their production to foreign nations in the Caribbean where the product could be produced more cheaply. Because most V.I. rum is shipped in bulk and sold under various generic labels at a relatively low price, there would be little or no negative sales impact from shifting rum production from the Virgin Islands to other countries.

Various "safety net" provisions being proposed to protect the Virgin Islands (and Puerto Rico) are grossly inadequate. For example, the current safety net provision (of Public Law 96-39) for return of rum excise taxes is by no means automatic, as is the reduction in import tariffs provided by that law. This safety net is subject to administrative interpretation and Presidential reduction or cancellation. Furthermore, appropriations for this purpose are only authorized through 1985.

2. Gasoline Excise Taxes:

Section 28 (b) of the Revised Organic Act provides for the return to the V.I. Government of excise taxes imposed on products manufactured in the V.I. and shipped to the U.S. Historically, this provision has been applied only to taxes on rum produced in the U.S. Virgin Islands despite the fact that since 1967 large amounts of U.S. revenue have been generated through excise taxes imposed on gasoline produced in the Virgin Islands. A recent decision of the United States Court of Appeals overturned a decision of the U.S. District Court for the District of Columbia, which would have returned retroactively these much needed revenues to the U.S. Virgin Islands. The issue of retroactive payment having been settled, the U.S. Virgin Islands no longer seeks this relief; however, Congressional action to return future gasoline excise tax revenues to the Territory could help to offset the negative impact of some of the concessions which a Caribbean Basin Initiative might provide to foreign nations.

The one-way free trade zone and extension of tax incentives for investment and conventions would severely damage all aspects of the U.S. Virgin Islands' economy. Gasoline excise taxes returned to the Virgin Islands would be used to directly improve our basic public infrastructure including utilities and port facilities. Also, channeling part of these funds into a local development bank would enable us to provide low interest financing to existing and potential businesses for the renovation and expansion of Virgin Islands industries and housing. Improved infrastructure and the availability of low interest financing may help to in part offset the negative impact on the U.S. Virgin Islands of the Caribbean Basin Initiative by making the territory more attractive to potential investors.

Already, through tax agreements with Hess Oil Virgin Islands Corporation and the proposed Virgin Islands Refinery Corporation, the U.S. Virgin Islands government has encouraged this industry to invest in the U.S. Virgin Islands and, specifically, to increase the production of gasoline. The U.S. Virgin Islands should benefit in some way from this contribution to U.S. revenues. We strongly recommend Administration support for Congressional action to provide for the return, prospectively, of gasoline excise tax revenues collected on gasoline produced in the U. S. Virgin Islands.

3. Airport Facilities:

Various nations in the region have upgraded or are in the process of upgrading their airport facilities so as to facilitate the expansion of tourism and other export-based industries. Through its participation in various international financing arrangements,the U.S. has aided these countries in improving their air transportation facilities.

To remain competitive,continued federal financing of the renovation and expansion of airports located in the U.S. Virgin Islands is essential. The existing airport on the island of St. Thomas is marginal for jet operations. Several aircraft have run off the runway's end with 40 lives lost and considerable damage to both aircraft and vehicles on the ground. Phase one of the airport expansion project which is currently underway, is now 80% complete and involves the creation of 98 acres of land requiring eight million cubic yards of fill. Federal funds totalling $37 million, and $8 million of local funds have been committed to this phase. The U.S. Virgin Islands Port Authority currently needs $40 million to complete phases two and three of the expansion of the St. Thomas airport facility. Phases two and three involve the construction of a 7,000 foot runway, a commercial terminal (to replace a converted World War II hangar) and ancillary improvements such as safety areas, lighting, taxiway, and access roads. Recent cut-backs in federal airport funds could seriously delay the completion of this facility at a time when competition for Caribbean visitors is intensifying and the U. S. is assisting foreign Caribbean nations to upgrade their tourism facilities. As part of the Caribbean Basin Initiative the Virgin Islands requests administration support for obtaining the needed funds to complete the expansion of its airport projects including the extension of the St. Croix airport runway to 10,000 feet, and expansion and renovation of the terminal.

4. Reduction of the 30% Withholding Tax:

For many years, officials in the U.S. Virgin Islands have been studying ways in which to stimulate new investments in the Territory. The Governor's Economic Policy Council has concluded that one of the prime deterrents to investment has been the 30% tax imposed by the U.S. Internal Revenue Code on dividends, interest, rents, and other passive income which is remitted from the Virgin Islands to the United States. In September 1981, Governor Juan Luis requested that the V.I. Delegate to Congress introduce legislation to permit the reduction of the rate of tax and to eliminate existing restrictions which in many cases limit the amount of this tax which can be credited against U.S. tax liability. On December 3, 1981, Congressman de Lugo introduced, with bi-partisan support, H. R. 5113 which encompasses the Governor's proposal to reduce the 30% tax rate to 10% with an option to permit the territorial government to reduce the rate further, if necessary to remain competitive with other investment areas. The bill permits United States recipients of Virgin Islands passive income to credit payment of the tax against U.S. tax liability without the restrictions now embodied in the foreign tax credit provisions of the U.S. Internal Revenue Code. The bill has been assigned to the House Ways and Means Committee.

Passage and implementation of the bill will make the U.S. Virgin Islands more competitive in attracting investment dollars. For the past five years, Puerto Rico has enjoyed the benefits of Internal Revenue Code Section 936 which permits companies to operate in the Commonwealth entirely free of U.S. taxes, including the 30% tax on repatriation of funds with which firms operating in the U.S. Virgin Islands are saddled. Many other countries in the Caribbean participate in tax treaties with the United States which permit repatriation at rates ranging from 5 to 15 percent. Thus, even if the United States were not now proposing new means to encourage investment throughout the Caribbean, the relief proposed by H.R. 5113 is essential to elevate the U.S. Virgin Islands to an <u>equal</u> competitive footing with our neighbors. In the context of the Caribbean Basin Initiative, however, enactment of this bill becomes essential if the U.S. Virgin Islands is to maintain any possibility of attracting new industry and new jobs. Should additional tax incentive programs be made available to other Caribbean economies, the Virgin Islands should also be in included in such programs.

As part of its Caribbean Basin Initiative, we recommend the Administration lend its full support to the Territory's efforts to gain passage of H.R. 5113, including supporting testimony by appropriate officials of the Administration during Congressional hearings on the bill, likely to be scheduled during February or March of 1982.

5. Tax and Trade Concessions:

Headnote 3(a) of the U.S. Tariff Schedules allows U.S. Virgin Islands manufactured commodities which have less than 50% dutiable foreign material components (70% in the case of watches and watch movements) to enter the U.S. duty free. In 1980, firms operating under Headnote 3(a) employed approximately 800 persons (about 25% of total manufacturing employment). This provision was intended to allow U.S. Virgin Islands produced commodities to enter U.S. markets at competitive prices and to provide some relief from higher transportation costs associated with U. S. Virgin Islands manufacturing operations. Headnote 3(a) is also a compensatory program to permit the U.S. Virgin Islands to offset the higher cost of operating under the U.S. laws and regulations, as compared to competing Caribbean economies.

We strongly object to the concept of a one- way free trade zone between foreign Caribbean nations and the U.S. In effect, this concept is an extension of the special privilege accorded to the U. S.

Virgin Islands producers under Headnote 3(a) to foreign countries in the Caribbean Basin and as such represents a serious erosion of a concession granted to the U.S. Virgin Islands to compensate our firms for the higher costs of operation under the U. S. laws.

For several years the U. S. Virgin Islands has requested that the U. S. Congress raise the dutiable foreign materials exemption to 70% for all U.S. Virgin Islands produced commodities to compensate for past and projected U.S. tariff schedule reductions and changes in international exchange rates which have reduced the benefits that have historically been derived from the 50% foreign materials provisions of Headnote 3(a). As a part of the Caribbean Basin Initiative, the Administration should propose that Headnote 3(a) be amended to provide for a 70% foreign materials exemption on all U.S. Virgin Islands produced goods.

We concur with Puerto Rico's assessment of the adverse consequences which extending tax incentives for investment and one-way reductions in customs duties would have on the industrial development programs of both the U. S. Virgin Islands and Puerto Rico. The U. S. Virgin Islands Department of Commerce recently completed a study which identified key industries, such as those manufacturing scientific and measuring instruments, pharmaceuticals, plastics, office and computing machines, electrical industrial apparatus, and electronic components and accessories which could profitably operate in the U.S. Virgin Islands. An extensive promotional campaign is currently underway to develop these industries and attract new firms to the U. S. Virgin Islands. The Caribbean Basin Initiative would seriously impair our ability to successfully diversify our economy if the products and industries noted above were included in the free trade zone and tax incentive program for the Caribbean Basin. Therefore, we recommend that industries producing these products along with rum and watches be excluded from free trade zone and tax incentive treatment.

We have reviewed Puerto Rico's proposal for Caribbean Basin Corporations. While we lack sufficient information to fully evaluate this alternative, it does not appear to be advantageous for the U.S. Virgin Islands. Products shipped from other Caribbean countries to the U.S. Virgin Islands would invariably be trans-shipped through Puerto Rico to the U. S. The additional transportation costs would effectively preclude the U. S. Virgin Islands from consideration as a location for a Caribbean Basin Corporation.

Finally, the U. S. Virgin Islands is currently not included under Section 936 of the Internal Revenue Code. Before considering Section 936-type investment incentives for U.S. firms operating in foreign nations, the federal government should work with the U. S. Virgin Islands in developing a program similar to Section 936 for firms operating in the U. S. Virgin Islands.

6. Territorial Development Bank:

Mr. Pedro Sanjuan, Assistant Secretary of the Interior for Territorial and International Affairs, recently expressed an interest in establishing a development bank for U. S. Territories. While the proposal is only in the concept stage, the U. S. Virgin Islands would support such a proposal as a potential source of low-interest funds for economic development and diversification. We urge that the proposal move forward, and be included for implementation in the Caribbean Basin Initiative.

7. Tourism:

Tourism is the industry which best utilizes the limited natural resources existing in the region. American tourists account for a substantial number of Caribbean visitors, almost 70 percent in 1980. Thus the success of the tourism sector in the region is closely tied to the internal conditions of the U.S. economy. U. S. monetary and fiscal policies, and actions by the Civil Aeronautics Board and other regulatory agencies impact on tourist travel to the area. The importance of this activity necessitates the formulation of special policies directed toward the development of the entire region's tourism potential. These policies should increase the number of tourists visiting the Caribbean including the U. S. Virgin Islands, and not merely redistribute the current flow at the expense of the U. S. Virgin Islands tourist traffic.

Airline Fares and Service: Foreign nations stimulate vacation travel to selected Caribbean destinations through subsidized fares on national airlines. In recent years the U. S. Virgin Islands has been served directly by only two U. S. trunk carriers, with such high load factors that discounts are not generally available, particularly during the peak tourist seasons. The United States, which has no government operated airlines, could compensate for this rate differential by subsidizing direct flights to the U.S. Virgin Islands. Two suggested methods for inclusion in the Caribbean Basin Initiative are: 1) U. S. tax credits to airlines of landing fees for aircraft flying direct to the U. S. Virgin Islands, and 2) personal income tax deductions for airfares for overnight visitors to the U. S. Virgin Islands. Under the latter proposal, for example, a visitor could be allowed a 50 percent (50%) tax deduction for airfare for one round trip flight to the U. S. Virgin Islands per year, provided that he remains in the U.S. Virgin Islands for at least three nights.

Convention Tax Deductions: As a result of the 1976 Tax Reform Act, the U. S. Virgin Islands has become an increasingly attractive convention destination. In 1981, the U. S. Virgin Islands will host 187 conventions and almost 23,000 convention guests, with an expected average length of stay of five days. This represents a 40% average annual increase in convention business since 1975. Clearly, the 1976 Tax Reform Act allowing tax deductions for conventions in the U. S. Virgin Islands has been a major boost to our economy. Also, conventioneers to neighboring Puerto Rico (which has significant convention business) often make day trips to the U. S. Virgin Islands for shopping and sightseeing. Extension of this benefit to other Caribbean economies can be expected to negatively impact our growing convention business and would jeopardize the value of existing investments in convention and recreational facilities initially stimulated by this concession to the U. S. Virgin Islands. We oppose an extension of this tax treatment to other Caribbean destinations without some equal compensating incentives for the Virgin Islands tourism industry.

Liquor Allowance: Currently, U. S. Virgin Islands visitors can return to the U. S. with four liters of liquor. The administration should consider permitting visitors to purchase a fifth liter of U.S. Virgin Islands rum as part of their duty free liquor allowance. This provision would help stimulate local rum production.

8. Virgin Islands Watch Industry: Current developments in the U. S. Virgin Islands watch industry exemplify the difficulty which the territory has in attracting and sustaining manufacturing industries even with current tax and trade concessions which are not extended to other Caribbean economies. During the past few years employment and production in the Virgin Islands watch industry has declined by 50 percent as a result of several factors including: an erosion in the value of the U.S. dollar vis-a-vis foreign currencies; reduction in U.S. tariff schedules; decreasing demand for mechanical timepieces; and the emergence of Hong Kong as a center for low labor cost watch exportation. To compensate for these changes and to revitalize the U.S. Virgin Islands watch industry, both local and federal legislation is being considered. On the local level certain tax exemptions in lieu of subsidies would improve the cash flow of the watch manufacturers. At the federal level, legislation is being drafted to eliminate the 70/30 ratio for watches under Headnote 3(a), and the Secretaries of Commerce and Interior would be empowered to establish such criteria for determining duty liability as would result in the maximum amount of direct economic benefit to the U. S. possessions. Labor input per unit produced

has been suggested as the most appropriate criterion. Further, to prevent a pass-through operation, it has been suggested that a $50.00 maximum landed value of foreign components per unit be imposed.

An essential element of the Caribbean Basin Initiative would be an assurance that federal legislation will be promoted to revitalize the Virgin Islands watch industry, and that concessions granted to other Caribbean economies would not jeopardize this important Virgin Islands industry.

9. Other Areasof Concern to the U. S. Virgin Islands: Establishment of the College of the Virgin Islands as a Research and Training Center for the Caribbean Basin Initiative: As the only American, English-speaking institution of higher learning in the Caribbean, the College of the Virgin Islands is in an excellent position to provide the training, research and expertise needed to further the economic, political, and social development of the region. A proposal has been submitted to the U. S. Department of Interior and planning funds have been appropriated by Congress to establish an Eastern Caribbean Center for Educational, Cultural, Technical and Scientific interchange at the College. Establishment of the Center would enable the College to share with neighboring Caribbean islands, strengthened programs of management training, agricultural research, fishing industry development and technical education.

The College of the Virgin Islands is uniquely suited to provide such research and training due not only to its geographic location at the mid point of a string of island - states within the Caribbean, but also because of the similarity of the cultures, traditions, and ethnicity that the Virgin Islands shares with many of the countries that the Caribbean Basin Initiative is designed to assist. During its twenty year history, the College has already reached out to its neighboring islands, and a large porportion of its students and faculty comes from the Eastern Caribbean.

Specific existing programs at the College, which could be expanded as part of the Caribbean Basin Initiative, include the Caribbean Research Institute which emphasizes micro state research designed to assist in the development of Caribbean island-countries; the Agricultural Experiment Station and Cooperative Extension Service which provides neighboring islands with technological assistance in improving food production; the Bureau of Public Administration which has been assisting local government employees in improving their management skills; and the Reichhold Center for the Arts which is dedicated to providing a forum for the exchange of artistic expression and cultural tradition among the islands.

As part of the Caribbean Basin Initiative, the administration should provide the funds necessary to implement this program which has been endorsed by both the Department of Interior, and Congress.

Testing and Development of Alternate Energy Resources: The Virgin Islands Government, through its Energy Office, and the Virgin Island Water and Power Authority have been exploring means of providing research and testing of alternate energy sources as one means to deal with the high cost of energy worldwide. Such efforts are particularly significant in the Caribbean where a very high proportion of energy is provided by foreign oil imports. Due to Caribbean weather patterns, the U. S. Virgin Islands is an ideal location for testing of wind and solar energy projects. Proposals have been submitted to the federal government to establish an Ocean Thermal Energy Conversion test project near St. Croix. St. Croix's proximity to the deepest ocean trench in the hemisphere, as well as the islands own need for reliable and efficient energy sources, make it particularly suitable as the location for this project.

Financing Assistance for Electric Generating and Water Production, Distribution and Storage Facilities: The Assistant Secretary of Interior for Territorial and International Affairs recently stated that one of the most significant obstacles to improving the economic development climate of the U. S. Virgin Islands and the other territories is the lack of sufficient reliable electric power. Our needs in this area and in the area of water production, distribution, and storage are immediate and continuing, and the Virgin Islands Government has regularly expressed them to both Congress and the Administration.

A comprehensive water and power plan to improve existing facilities and to provide new ones was presented last year. In order to fund these projects the federal government, as part of the Caribbean Basin Initiative, could assist the Virgin Islands through a coordinated program of direct grants and loan guarantees for tax exempt bonds. Without such assistance, the local government will be hard pressed to obtain the necessary capital funding for a level of electric service and water supply which will attract industry and provide its citizens with reliable water and electric power service.

Improving Inter-Island Maritime Transportation: Regularly scheduled and reasonably priced inter-island transportation services in the Caribbean are virtually non-existent at this time. A basic transportation network is essential for the economic development of the region, and it will become even more important as the other elements of the Caribbean Basin Initiative begin to stimulate increased trade in the region. With the completion of a modern containerport on St. Croix, expected within the next few months, the Virgin Islands will have one of the elements it needs to become a transportation link to the rest of the Caribbean. Increased imports of food products from our island neighbors could be combined with canning and packaging plants to create new jobs in the Virgin Islands, but such development is unlikely to occur without federal assistance. A federal subsidy program for inter-island shipping companies would contribute significantly to reducing the costs of trade among the nations of the region and thus turn the concept of "free trade" in the Caribbean into a viable reality.

<u>Virgin Islanders as Ambassadors to the Caribbean and the World</u>: Presently two Virgin Islanders serve as U.S. Ambassadors: Terrence Todman is the Ambassador to Spain; and Melvin Evans is the Ambassador to Trinidad. They help reflect the spirit of friendship and diplomacy for which Virgin Islanders have long been known. Because of our close political, social, and cultural ties to the rest of the Caribbean, Virgin Islanders are particularly suited to serving their country through diplomatic posts. The federal government should increase the number of Virgin Islanders in ambassadorial and consular positions in the Caribbean and elsewhere in the world.

<u>Participation by Virgin Islands Representatives in All Caribbean Basin Initiative Consultations and Negotiations</u>: The Virgin Islands joins with Puerto Rico in requesting that both the Territory and the Commonwealth be included in discussions between the United States and Caribbean countries on the Caribbean Basin Initiative. Not only will this give us a greater knowledge and understanding of the policy and its implementation, but the participation

of the U. S. Caribbean territories in United States delegations and meetings with other Caribbean nations will also symbolize the nation's commitment to the region.

f GC (Mahoney)

Mahoney, Daniel

J. DANIEL MAHONEY
45 EAST 29th STREET
NEW YORK, N.Y. 10016

212-689-8400

STATE CHAIRMAN
CONSERVATIVE PARTY

June 23, 1982

The Hon. Michael K. Deaver
Assistant to the President and
Deputy Chief of Staff
The White House
Washington, D.C. 20500

Dear Mr. Deaver:

I met with Jim Baker and Jim Cicconi recently, at which time I raised the question of inviting President Reagan to attend a twentieth anniversary celebration for the Conservative Party of New York State in the fall, and was advised that I should address this invitation to you.

As you know, the Conservative Party of New York State was founded in 1962. I believe that President Reagan's first major political appearance in New York State was at the Conservative Party's annual dinner in 1975. The Conservative Party has been advocating President Reagan's election to that high office consistently since the 1968 presidential campaign.

We have in mind a celebration that would feature a musical performance by Lionel Hampton and company at The Rainbow Room, 30 Rockefeller Center, Manhattan. Both to accommodate the President's schedule and to avoid any conceivable political complications, we would conduct this affair after the election. We have reserved The Rainbow Room for December 6, 1982, and Mr. Hampton is also holding that date. In the event that this date is impossible for the President, it might be possible to reschedule for November 29.

The speaking program would be extremely short, and would consist of President Reagan, Wm. F. Buckley, Jr., and statewide Republican officials elected with the endorsement of the Conservative Party.

The Conservative Party has not requested any appearance by President Reagan since he took office. As you can well imagine, the twentieth anniversary of the Party's formation is an occasion of high importance to us, and we would be very grateful if it would be possible for President Reagan to honor us by attending.

Thank you for your consideration of this request. Please communicate directly with the undersigned if you have any questions with respect to this invitation.

Sincerely yours,

Dan Mahoney

J. Daniel Mahoney

JDM/jh

cc: The Hon. Edward J. Rollins

THE WHITE HOUSE

WASHINGTON

March 9, 1982

Dear Dr. Manacher:

Thank you for your recent letter supplementing material you had sent earlier.

I have reviewed it, and have forwarded it to Murray Weidenbaum for his consideration.

Again, we appreciate your sharing your thoughts with us on this matter.

Sincerely,

James W. Cicconi
Special Assistant to the President

Dr. Glenn K. Manacher
Associate Professor
University of Illinois at
Chicago Circle
Box 4348
Chicago, Illinois 60680

cc: Murray Weidenbaum

UNIVERSITY OF ILLINOIS AT CHICAGO CIRCLE
DEPARTMENT OF MATHEMATICS
COLLEGE OF LIBERAL ARTS AND SCIENCES
BOX 4348, CHICAGO, ILLINOIS 60680
TELEPHONE: 996-3041

March 4, 1982

Mr. James Cicconi
Special Assistant to the President
The White House
Washington, D.C. 20500

Dear Mr. Cicconi:

The enclosed report completes the material I sent you in November on an alternative to Reaganomics in which capital gains taxes focused on productive investment replace the present diffuse approach.

In the original report, a trade-off between real interest rates and the rate of inflation was postulated. The idea that this trade-off had recently become so acute that it would produce an inverted relationship between the rate of inflation and nominal interest rates -- something new and ominous -- was only hinted at.

In this paper a theory of the malaise is outlined, and some rather terrifying consequences outlined. More pertinently, a simple theory of acceptable vs. unacceptable deficits is given, together with a list of policy suggestions directly entailed by it.

Despite the fact that you had some reservations before, please look over this material carefully. The purpose of this paper is to carefully substantiate the inverse relationship between the nominal prime rate and the long-term inflation rate that was only introduced ad hoc in the last paper. If its conclusions are right, then I am afraid you will have to change your policy in the not too distant future.

In the mean time, would you please transmit this report to Mr. Weidenbaum with a request that it be considered as an integral part of the material I sent you in November?

Yours sincerely,

Glenn K. Manacher

Glenn K. Manacher
Associate Professor

GKM/tb

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February 25, 1982

Mr. William R. Buechner
Senior Economist
Joint Economic Committee
Washington, D.C. 20510

Dear Mr. Buechner:

On October 1, 1981, I sent you a detailed proposal for revising the capital gains tax structure in order to enhance the incentive toward long-term primary investment. I argued that the economy is trapped by high deficits into a trade-off between unacceptable interest rates and unacceptable inflation, depending on whether borrowing or monetizing is used to cover the deficit. I further argued that the trade-off is presently so poor that only a lowered deficit or a seriously weakened economy can produce a substantially better trade-off. I concluded that in the present climate, very little of the tax advantage given to the wealthy would necessarily be productively invested and that a far more focused source of investment capital had to be found.

The existence of this trade-off was one of the key points in support of my scheme. However, it was introduced <u>ad hoc</u>, and the scheme has been critized on this ground. In this letter, I would like to present some evidence that a sharp trade-off between real interest rates and the rate of inflation <u>does</u> exist at the present time, and that its consequences may be ominous.*

The traditional view is that in the absence of strong competition for funds, the <u>nominal</u> prime interest rate is positively correlated with the rate of inflation. The idea is that in an easy capital market, there is a nearly constant "banker's markup" added to the rate of inflation in computing the nominal prime interest rate. In the past the markup was about 2%; now it is about 2½% (or in some cases about 3%). This rule is sometimes called the "Fisher effect". It is not disputed here.

A second effect is that any large-scale borrowing, governmental or corporate, must create competition for existing capital and thus raise the real interest rate, if only by a miniscule amount. I shall call this the "congestion effect".

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*The word "real" was omitted from "interest rate composite" in the graph in the October 1 report.

In order to be quantitative about the congestion effect, we need a model for congestion. A strong basis for such a model has been provided by Tony Boeckh, Editor of the Montreal-based Bank Credit Analyst and its companion Interest Rate Forecast.* Boeckh discusses the current malaise in a very important interview titled "Vicious Cycle -- Deficits Do Count" which appeared in the February 15, 1982 issues of Barron's.

In discounting the argument that the ratio of the federal deficit to GNP has critical bearing on interest rates, he points out that this ratio was as high as now in the 1974-75 recession without its having a serious effect on interest rates. He believes instead that the crucial determinant of real interest rates is the ratio B of the sum of annual federal borrowing and annual corporate borrowing divided by the national gross savings. Gross savings, as he defines it, are savings which include the value of durables, such as houses, suitably depreciated. He points out that the rate of gross savings as a fraction of GNP is comparable in all of the major industrialized countries, and that moreover it has remained almost constant for many years.

Boeckh's data indicates that there is a critical level of the B ratio, beyond which competition for available capital in the form of savings becomes intense and causes real interest rates to increase dramatically. It appears from Boeckh's data that this critical ratio, which I will call B_0, is about .51.

One can conservatively extrapolate Boeckh's reasoning as follows. Define the closely related ratio A to be the sum of the annual federal deficit plus corporate borrowing, divided by gross savings. Clearly A will equal B if the deficit is covered entirely by borrowing and A will be substantially lower than B if the deficit is monetized.

The degree to which the deficit is monetized - and federal borrowing is avoided - is measured by the annualized rate of change of M_{1B}, which I will denote M'. It follows that real interest rates will rise as M' is decreased, and (following Boeckh's theory) the degree of the rise depends on the size of A. If A is small, then as M' is reduced, the real prime rate P will not become much bigger. On the other hand, if A is fairly large -- in particular, if it is close to or in excess of $B_0 = .51$--then as M' is reduced, B will climb toward A, and in consequence P will rise sharply. Working through the details, it is rather easy to show that the relationship between M' and P has a strikingly

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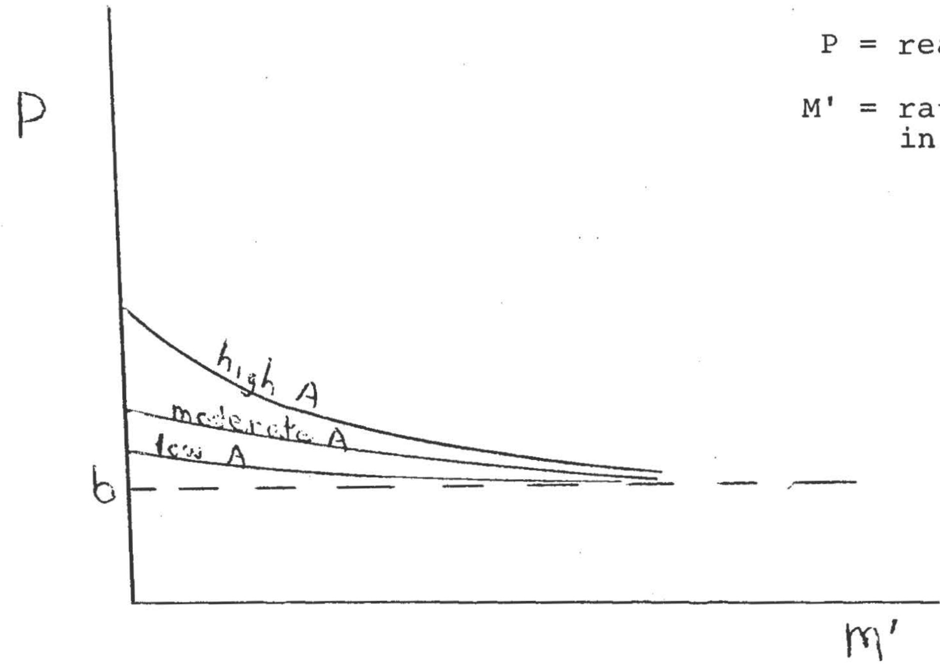
*These two newsletters are perhaps the most sophisticated and respected publications available in the field of money market analysis.

simple form, dominated by a few simple features. It is shown in Figure 1.

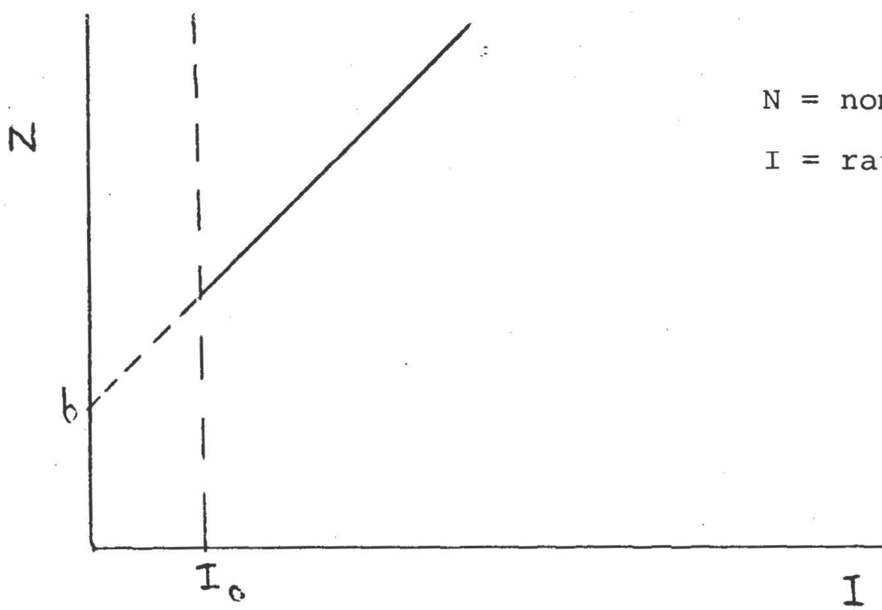


P = real prime rate

M' = rate of increase in M_{1B} per year

Figure 1. The Congestion Effect

An equally simple graph shows the Fisher effect which, it should be remembered, assumes that A is small.



N = nominal prime rate

I = rate of inflation

Figure 2. The Fisher Effect

In Figure 2, N is the nominal prime rate and I is the rate of inflation. I_0 is the "secular" rate of inflation, that is, the minimum rate of inflation built into the economy by external factors beyond the control of policy.* The curve is simply that of the equation $N = I + b$.

It should be stressed that Figure 1 shows the effect of varying M' while holding A constant. If general conditions worsen, corporate borrowing will probably decrease, unemployment will almost certainly increase, and the federal deficit will almost certainly increase. In addition, gross savings will probably be eroded. So two out of three of the factors affecting A will cause A to worsen, i.e., to get larger. This indeed might stimulate a "vicious cycle".

No one will dispute the reasonableness of Figures 1 and 2. What is in hot dispute are two questions.

(A) Is the congestion effect ever strong enough to overwhelm the Fisher effect?

(B) Is an unusually high value of N, such as now exists, evidence of a mix of two forces, one the congestion effect, the other a "psychological" expectation of imminent reflation? Putting it another way: Is a high value of N necessarily an indication of severe congestion?

Consider first (A). First let me repeat some well-known arguments that the answer is presently no. These arguments are favored by Administration spokesmen and many "supply side" economists.

(i) During the period 1955-1979, studies show persuasively that the nominal prime rate was positively correlated with M', strongly suggesting that the Fisher effect predominated (This fact was conveyed to me by Prof. Frederick Mishkin of the Department of Economics at the University of Chicago).

(ii) Prof. Milton Friedman studied data from October 6, 1979, when the Federal Reserve Board changed the basis of its policy from interest rates to bank reserves) to the present. He showed that there was a slight positive correlation between M' and the interest paid on 90-day Treasury bills, allowing 4 weeks' delay. In particular, violent oscillations of M' produced slight but definite oscillations in the T-bill rates; the two were in phase.

*I_0 is presumably around 3%.

Consider now arguments that the answer to (A) is presently yes.

(i) A number of distinguished economists, among them Alan Greenspan, Paul Volcker, and Tony Boeckh, have expressed their belief that federal borrowing has absorbed savings excessively and has sharply driven up interest rates.

(ii) It is almost clear that the October, 1979 change in Federal policy caused a tremendous leap in interest rates, and that this increase has dwarfed every fluctuation since then, with the single bizarre exception of the quickly-dispersed April, 1980 dip.

(iii) Boeckh's entire article strongly supports this view.

I believe, then, that the evidence strongly suggests a "yes" answer to (A): that the deficit is so large that it is possible for the nominal interest rates to rise as the inflation rate falls. To see how this can come about, let me now state exactly what it means for the congestion effect to dominate the Fisher effect. I will then show that some ominous policy consequences follow.

To establish an easy comparison between Figures 1 and 2, let us suppose that the Fed is on a steady course, so that the inflation rate has a chance to stabilize once a steady long-term average growth in M_{1B} has been established. (Milton Friedman argues on the basis of large quantities of retrospective data that the time to stabilize is on the order of 18 months plus or minus 6 months.) Once such stability is reached, we can assume that M' and the rate of inflation are roughly equal, following monetarist theory. In that case, we may plot the joint effect of the congestion effect abd the Fisher effect as a graph showing the relationship between the nominal prime rate N and the time-stabilized inflation rate I. This is shown in Figure 3.

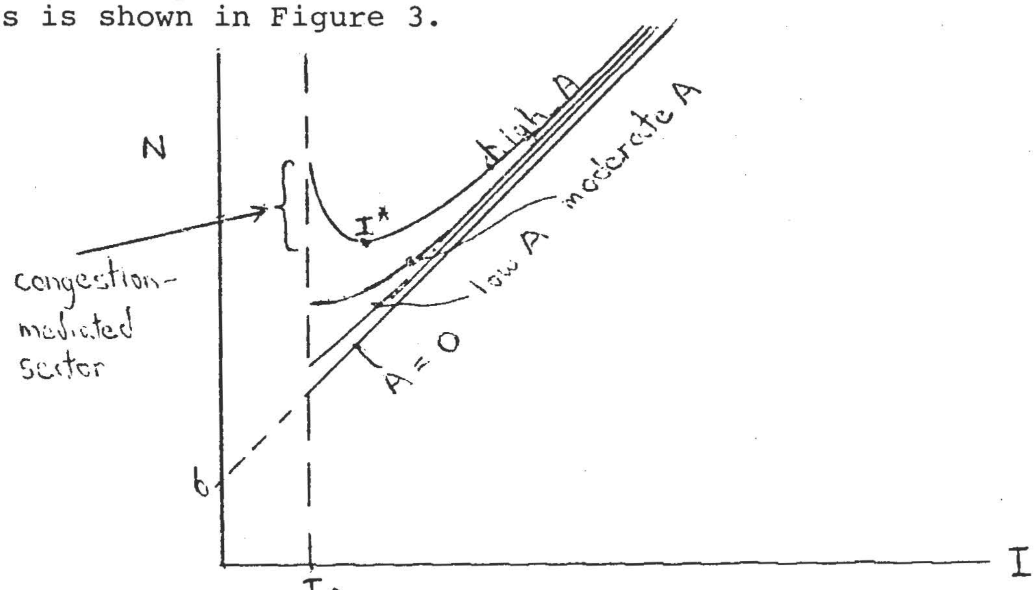


Figure 3. Combined congestion and Fisher effects.

Figure 3 shows dramatically what it means for the congestion effect to dominate the Fisher effect. It means that the curve showing the relationship between N and I will have a minimum for some value of I greater than I_0. The curve will show a "congestion-mediated" increase in N for I lower than that value. The reason for this is, of course, that in an environment simultaneously with very high deficits and high levels of corporate borrowing, lowering M' entails additional borrowing by the treasury, which drives up real interest rates so strongly that their increase exceeds the decrease in the inflation rate.

When a minimum in the curve occurs, the value to the economy in further reducing inflation is lost, and it becomes counterproductive and dangerous to do so. That is the first appalling policy consequence. Further: very rough estimates of the shape of fig. 1 indicate the following approximate rule: when A is high enough to produce a minimum in figure 3, the resultant nominal inflation rate will be at least about $2I^* + b$, where I^* is the value of I at which the minimum occurs. Crude estimates indicate that I^* is presently about 6%, so that we have an even crueller consequence: With current levels of A, no combination of borrowing and/or printing money to cover the present deficits can lower the nominal interest rate much below about 14½%. *This provides a way of looking at Henry Kaufman's prediction on minimum interest rates, which is 14%, and also validates Boeckh's remark that the Reagan Administration is "locked into" high interest rates.

* * * * * * * * *

From the evidence we have presented, we believe

(a) That before October, 1979, the rise in interest rates was inflation-mediated.

(b) That subsequence to October, 1979, the further rise in interest rates was congestion-mediated.

(c) That the tendency of interest rates to settle down somewhat since October, 1979 was due mainly to a time-lag effect in which the shock effect of the decrease in M' was later somewhat softened by the resulting decrease in inflation, and does not necessarily mean that interest rates were inflation-mediated.

(d) That the nominal prime rate is "locked into" a rate higher than about 14½% regardless of impressive progress in reducing inflation.

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* Except, of course, if money were suddenly injected into the economy, which would cause a sudden but unstable drop in the interest rates.

(e) That the cause of this malaise is the high federal deficit at a time when corporate borrowing, despite the recession, is relatively high.

(f) That continuation of these policies may lead to higher unemployment, further and worsening underinvestment, larger deficits and less savings.

(g) That only a fraction of the money released into circulation through tax cuts has been applied to primary investment, whereas the resultant deficit has greatly discouraged investment.*

(h) That reflation is not an acceptable alternative.

(i) That capital for eventual recovery is available through other mechanisms than a general tax cut. (My Oct. 1 letter details a mechanism that is much more efficient and that reduces revenues to the treasury only after the investment has been made and has proven effective).

(j) That the reduction in the deficit, in order to lead the economy out of the high-interest-rate trap, need not be gigantic; that in fact all that is necessary is to reduce it enough to prevent congestion-mediated increases in nominal interest rates (See fig. 3). Recent history suggests that this can be done by lowering the deficit to 50 billion dollars during the current recession and then allowing it to decline substantially further as the economy improves. My theory suggests that if this were done, the nominal prime interest rate would soon fall to a little above $2I_0 + b$, which is about 8½%..

(k) That once (j) is done, a scheme such as my differential capital gains tax plan might further reduce the effective cost to business for primary capital construction.

(l) That the reduction in inflation, shortened depreciation schedules for corporate investment, and the ending of "automatic" increases in the federal budget are the three solid achievements of the present administration toward a climate in which massive investment will be possible, but the continuation of present policies will not bring about the combination of low interest rates, low inflation, and sustainable healthy demand that massive investment requires.

* "Why Business Won't Invest". New York Times, Sec 3, January 31, 1982.

A few words should dispose of (B). Ample evidence has now been adduced that the Fed will hold the line on M_{1B} growth. The fact that real interest rates have held rather steady despite erratic medium-term fluctuations in M_{1B} growth suggests that expectations of imminent reflation are unfounded. With regard to long-term expectations, perhaps 5-10 years of ruinous interest rates would "chasten speculators" and convince them that their "psychology" is remiss, but this belongs to the realm of black comedy. A better way to get the long-term rates down is to get the short-term rates down and keep them there. The best way to do this is to reduce the deficit, and to give up on the pipe dream that tax savings are at present the best source for long-range investment (In my Oct. 1 proposal, I suggest a much better and more targeted source).

Yet one more point should be made. Tex reductions are supposed to increase the pool of savings. They can sometimes have the reverse effect. If some part of the money put in circulation by tax breaks is consumed, but the government must then borrow back <u>all</u> it lost on account of the tax break, it takes no mathematician to see that the aggregate savings available for reinvestment may thereby be <u>depressed</u>. Yet such calculations pass curiously as "supply side".

Yours sincerely,

Glenn R Manacher

Glenn K. Manacher
Associate Professor of
Computer Science

GKM/tb

Manacher, Glenn K.

February 8, 1982

Dear Dr. Manacher:

I appreciate the copies you forwarded of your economic views, as conveyed by letters to the Joint Economic Committee.

While there are points at variance with this Administration's economic policies, as well as with my personal views, I have read your papers with interest. I have also taken the liberty of forwarding copies to Murray L. Weidenbaum, Chairman of the Council of Economic Advisers.

Again, thank you for sharing your analysis with us.

Sincerely,

James W. Cicconi
Special Assistant to the President

Dr. Glenn K. Manacher
Associate Professor of Computer Science
University of Illinois at Chicago Circle
Box 4348
Chicago, Illinois 60680

cc:

Murray L. Weidenbaum

UNIVERSITY OF ILLINOIS AT CHICAGO CIRCLE
DEPARTMENT OF MATHEMATICS
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BOX 4348, CHICAGO, ILLINOIS 60680
TELEPHONE: 996-3041

December 22, 1981

Mr. James Cicconi
Special Assistant to the President
West Wing
The White House
Washington, D. C. 20500

Dear Mr. Cicconi,

Enclosed please find the report we discussed on focused supply-side policies. As you know, we have quite different approaches to the economics of production.

Since this report stresses efficient mechanisms and the importance of keeping interest rates down, I trust you will read it carefully and that you will supply Mr. Baker a copy.

If I can be of use, or some clarification is needed, do not hesitate to get in touch.

Yours sincerely,

Glenn K. Manacher

Glenn K. Manacher
Associate Professor of
Computer Science

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October 1, 1981

Mr. William R. Buechner
Senior Economist
Joint Economic Committee
Washington, D.C. 20510

Dear Mr. Buechner:

I am pleased to present to the Joint Economic Committee, at your invitation, an updated and comprehensive version of the investment-oriented tax plan I first sketched at the request of Scott Cohen, Chief Administrative Aide to Senator Charles Percy. A copy of the preliminary plan was also submitted to James Galbraith, Executive director of your committee.

As you know, this plan is an attempt to reinvigorate the productive capacity of the United States. It does so in part by discriminating between the tax rates for primary or productive capital investment, meaning construction and modernization of capital plant, secondary capital investment, which creates the market for primary investment, and unproductive investment. At the same time, it should help significantly to bring the budget into balance.

This plan, which I will describe in some detail shortly, was presented in an early form to Senator Percy and to the Ways and Means Committee. It elicited a careful and thorough reply from Senator Percy, which is enclosed. Extensive discussions with colleagues, as well as with Bruce Davie, Economist for the Ways and Means Committee, revealed a number of obvious and hidden flaws in the original plan. I shall refer to them in the present report with attribution.

The plan was conceived in January, 1981, as the Reagan tax proposals were taking shape. It was clear to me then that very little of the tax advantage given to the wealthy would necessarily be invested productively. The correspondence with Senator Percy indicated his disagreement; he favored lower capital gains taxes across the board. Setting forth his reasons, he emphasized the recent study by Oscar Pollack of the investment firm of Ingalls and Snyder which showed that the capital gains tax (CGT) reduction of 1978 produced a major lift in the stock market, increased disbursements to venture funds, and most importantly, produced a reflow to the treasury resulting from increased business activity that not only made up for the tax shortfall, but actually produced a small net gain.

On examining the in-depth justifications put forth in defense of the Reagan Economic Recovery Program, I could find only two major credible studies: The Pollack study mentioned above, and another which showed that every major surge in capital investment in the last century has been preceded by a tax reduction that presumably acted as its stimulus.

I believe that both of these studies are valid and significant, but that they cannot be used as a credible defense of present Administration policy. My proposal is put forward as a coordinated set of supply-side policy instruments which I believe are better tuned to present realities.

It is not just "supply-siders" who are alarmed at the present 15.5% ratio of investment to domestic GNP. The belief is almost universal among economists of every political stripe that a 3% increase, to 18.5%, is the minimum necessary to reinvigorate our economy to the point where it is efficient and competetive. The underinvestment expressed by this ratio has been with us since the Viet Nam war. Takeovers and importing have replaced capital construction and domestic manafacturing in many of our industries.

The present environment is, I believe, profoundly unconducive to large-scale productive investment. The dilemma we are in can in part be visualized by reference to a "trade-off curve" which now appears to exist between interest rates and the rate of inflation. The idea is shown in rough form in the figure below.

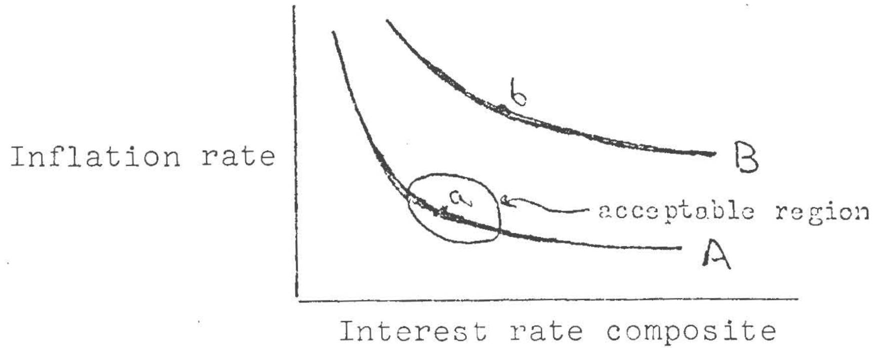

Figure 1. a and b are the "best points" on A and B.

In figure 1, A represents an economy with acceptable deficits, healthy productivity and a competitive capital plant; B represents an economy with unacceptable deficits, mediocre productivity and an aging capital plant.

Formerly, the economy tended to show a trade-off between inflation and unemployment. The figure was called the "Phillips curve." Milton Friedman has argued forcefully that a sufficiently inflated economy would not remain on a single Phillips curve; the uncertainties induced by inflation would curb investment and would cause the economy to track a worse curve: The curve looking like "A" would soon look more like "B".

I believe that a similar set of curves now exist for inflation vs. interest rates, and that three main factors determine which curve one is on: The federal deficit, the strength of the industrial base, and the underlying inflation rate. At the present time, we are quite possibly on a curve much more like B than like A.

It would appears that the federal deficit may recently have become the primary controlling factor. This was not always so; indeed, a central tenet of monetarist theory holds that deficits in themselves do not automatically produce either inflation or sharply higher interest rates. However, in the past, the underlying inflation rate was much lower, so that partially monetizing the debt could be done from time to time without ruinous effect. The other side of the coin is that when the prime rate was much lower, federal borrowing could be more easily accomodated; even when it competed with industrial and private capital markets, the resultant increase in borrowing rates was more of a nuisance than a real deterrent to investment as it has lately become.

This, however, is now history. At present, the inflation rate is severe enough so that even a small exacerbation produces flight of investment capital into gold, real estate, foreign currencies, mergers, etc. At the same time, the interest rates are high enough so that each exacerbation produces massive postponement of capital spending and the shifting of more money into money markets. In addition, it has the insidious effect of producing more roll-over borrowing by the government, since the interest paid itself becomes a not inconsiderable component of the short-term debt.

What makes the situation different today, then, is that without inducing a serious recession, there appears to be no combination of financing and/or borrowing to cover large deficits that will maintain both the inflation rate and the interest rates at levels compatible with large-scale primary investment. That is grim message imparted by curve B. Even attempts to "fine-tune" so that the "best" point b is achieved are insufficient. In contrast, a large range of points around point a are acceptable on curve A.

According to this theory, the federal deficit in good times need not seriously injure the economy, but in bad times it can become (and, I believe, has become) the key to whether the trade-off between inflation and interest rates will be acceptable or not.

This theory means that to force the curve into more acceptable terrain, i.e., to make it more resemble curve A, the two chief policy options are reducing the federal deficit and weakening the productive base, that is, inducing a recession. If the deficit is as strong a controlling factor as I suspect it is, it means that <u>in the absense of reduced deficits, it will take a severe recession to produce only a moderate shift of the curve toward A</u>. If a severe recession is induced, it will become yet another reason why necessary investment is further delayed. By that time, Japanese penetration into critical American industries--semiconductor products in particular--may become so intense that recovery of these industries is out of the question.

This is why reduction of the deficit (and thereby of interest rates) is the key first step. However, even after this begins to take effect, it is unlikely that merely putting more money into the hands of wealthy potential investors will result in $60 billion in new productive investment per year. In former times, productive investment was the main lure for capital. Today it is not. That is why a well-targeted source of $60 billion per year must be identified and provided an incentive as a matter of national policy.

I believe that the only source large enough and safe enough for productive investment of this magnitude is the huge pool of money now chasing nonproductive profit.

In these terms, the near-irrelevancy of studies that show (correctly) that times of high investment have been historically preceded by tax reduction should be clear: They do not predict that investment will result from the current round of tax reductions.

With regard to the Pollack study, the accompanying chart (figure 2) taken from the Venture Capital Journal is instructive. Venture capital was already sharply rising in 1976-78, but was certainly given a boost by the CGT reduction of 1978. Stock market volume increased too, generating massive inflow to the treasury. However, very large drops in the stock market, which have occurred four times since 1978, have erased most gains. New capital raised through initial stock offerings showed percentage gains comparable to those of figure 2, rising from $153 million in 1977 to $250 million in 1978 and then to $506 million in 1979*. These too, however, were also sharply on the rise before 1978.

The trouble with overapplying the Pollack study is severalfold. First, the mere fact of increased economic activity--even that sufficient to generate a compensatory reflow to the treasury--is not necessarily the evidence of productive investment. Secondly, the evidence provided that productive investment indeed took place centers on venture capital and new stock offerings, both of which are characteristic of highly leveraged, "go-go" businesses, such as oil drilling or high technology. Thirdly, the sum of the two, for 1979, was only $1.5 billion--vastly less than the $60 billion or so that represents the 3% of the domestic GNP needed for reindustrialization.

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*Letter from Senator Charles Percy to Senator Russell Long, August 12, 1980.

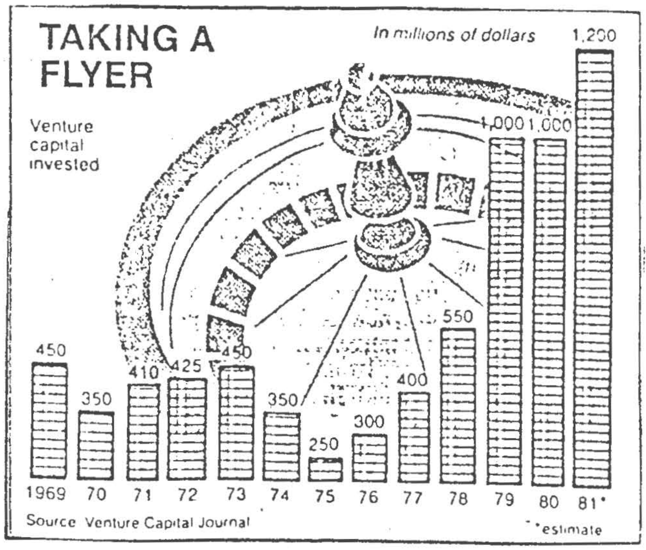

Figure 2.

There is a school of thought that argues that perhaps the case for reindustrialization is overstated. This school holds that "smokestack" industries have had their day; that America should now concentrate on exotic technologies. According to this view, Japan is somehow a more "natural" habitat for the steel industry than Ohio.

Should such a manafacturing exodus take place, there would result, according to Felix Rohatyn, a vast belt of near-poverty stretching from the Northeast to the Midwest. Emma Rothschild, in a series of brilliant articles on the American Labor Economy in the New York Review has shown conclusively that the reason for the unemployment rate not being lower than it is is that a very large number of American now work at very poor jobs, for instance in the food trades or in sales positions. This trend would surely be accelerated if the remaining industries in the Northeast-Midwest "crescent" were to disappear. Rohatyn has perceptively observed that America cannot tolerate, morally or economically, being reduced to a purveyor and servicer of goods produced elsewhere. Beside this, such a development would further increase the hemmorhaging of American capital abroad.

My proposal begins with a sharp distinction between three types of investment:

(a) "Primary," productive investment--in capital plant or modernization.

(b) "Secondary" investment--in markets whose strength directly affects and supports primary markets, chiefly the stock market.

(c) Unproductive investment--investments in hedge markets, art, real estate (with the exception of a personal domecile), land, and all types of foreign investments.

I propose that the tax rates be made to reflect this difference. For instance, whereas under the present codes, the largest long-term rates for all of these are at most 20%, the new maximum rates would be, perhaps, resp. 15%, 28%, and 50%. Sales of personal homes and certain kinds of personal property would continue to be shielded.

I will come shortly to the question of primary securities that bear interest and show how these too can be treated so as to produce an emphasis on primary investment. For the moment, however, let me focus on securities in which capital gains are the main attraction.

My proposal begins with the observation that capital in large amounts from external sources usually requires a major market offering in which stocks, bonds, or debentures are sold. This invariably requires the filing of a prospectus with the SEC, at which time the prospectus is subject to careful scrutiny.

Now suppose there were a new, "special," very low tax rate applicable to new offerings, provided such offerings were entirely for the purpose of real investment. Suppose, for the sake of illustration, that this special tax rate were 10%, and that the "normal" CGT rates were substantially higher.

Of course, few public offerings are purely for primary investment; more typically, some fraction is for land acquisition, debt retirement, etc. The fraction of each offering earmarked for primary investment purposes, as opposed to general purposes, would be carefully spelled out in the prospectus, and the tax rate computed accordingly. The computation would be subject to approval by the SEC or some other branch of the Treasury Department; presumably the work involved in this approval would be a very minor component of the overall prospectus review.

Suppose, for instance, that an offering called for 70% to be spent on primary investment and 30% for general purposes. Then 70% of the amount put up by the investor would be taxed at the special 10% rate, and the other at the normal CGT rate.

Special gains would be realized by the purchaser* of the newly-offered securities at the time of their sale. Such special gains could be claimed on a one-time-only basis; that is, any subsequent purchaser would realize only normal CGTRs since, in the frame of reference of this scheme, his gains would only be "speculative". This scheme would be very easy to police, since tax returns claiming the special tax rate would have to be accompanied by a certificate issued at the time of the original offering. It certainly would be no more complex than the procedures used now for any number of tax shelter schemes.

In all cases, the special rate(s) would apply only to the original purchaser and such heirs as might inherit the securities.

Mr. Bruce Davie, of the House Ways and Means Committee, has pointed out that even with these changes in place, the existence of high interest rates would still act as an overwhelming deterrent. This is a powerful argument. Let me now indicate how it can be met.

If I may indulge for a moment, I would like to offer my theory on why interest rates are so high, since this is germane to the whole plan. I believe the overwhelming reason is that large government borrowing not only crowds out competition, but creates significant and growing unsatisfied demand for borrowed cash at just below the rate paid by the treasury. For the treasury to borrow the enormous sums it requires, it must borrow above the pent-up demand. However, the borrowing is so large that it effectively shuts out the pent-up demand and thus causes it to enlarge, <u>even in a somewhat sluggish economy</u>.

If this theory holds, then the first step is to raise tax receipts to a level at which federal borrowing will be greatly reduced. This is exactly what is now proposed by Lester Thurow, who proposes a Value Added Tax (VAT). A smaller VAT coupled with the plan I am proposing might also be able to achieve the same effect. As interest rates fell, interest would be refocused on primary investment, because of the tax differential. At the same time, no new money would be injected into the economy, so that from a monetarist's point of view, inflation would not result. The health of the secondary market would be assured by its relative protection.

This proposal still leaves open the vexing question of how interest-bearing securities such as bonds, debentures, and preferred stocks could be handled so that primary investment would again be stimulated. Large companies often prefer issuing these to watering their common stock, and they are perhaps the chief instrument of massive long-range external corporate finance.

One suggestion often made is simply to tax the interest paid

* Or his heirs

on securities bought on primary offerings at a very low rate, as long as these securities are retained by their original purchaser or his heirs. This idea, which is superficially similar to a Japanese scheme in which interest paid on less than a certain amount of savings is tax-exempt, has two interrelated defects that were pointed out to me by a staff member of the Ways and Means Committee. The first is that it would invite a scam stemming from the fact that interest payments are deductible from income in the United States but not in Japan. The scam consists of borrowing money to pay for such securities, then taking advantage of the fact that the effective interest rate (tax consideration included) may well be less for the money borrowed than for the securities purchased. The government would in effect become a party to the scam.

The second defect is that if the tax rate on interest received is low enough, such securities would conflict directly with municipal bonds and other public tax-free instruments, depriving local governments of much-needed capital for public works.

The second defect can be partially remedied by making a moderately high percentage (say, 40%) of the interest subject to taxes. Another, probably more powerful idea is to encourage the issuance of convertible bonds, debentures, or perferred stock, allowing them to be taxed at the time of sale on the same basis as stocks obtained in primary offerings (as explained above) but subjecting some percentage of the interest paid (say, 30%) to immunity from taxation. These securities would pose considerably less threat to the municipal bond market, yet would offer a double tax incentive.

The first defect, surprisingly, appears to have a technical remedy, avoiding the scam mentioned above. Suppose the investor has received annual interest; suppose the part qualifying in principle for immunity is S dollars and the rest is I dollars. Suppose he has paid P dollars on all transactions except loans on homes of his personal residence or personal property. Then special treatment will be accorded only to that portion of S which, when added to I, exceeds P.

The essential idea of this computation is that it would be only original, not borrowed cash which, when invested in primary interest-bearing securities, would qualify for special treatment on interest received.

Having now given the technical basis for my proposal, I would like to make several remarks of a moral and political nature.

1. It is now proposed that benefits need to be removed from e.g., school lunch programs because the capital is urgently needed for "supply side" purposes. I have argued that the capital is available eleswhere. Even if it were not, and one granted the

proposition, it would still be an ethical necessity that the transfer be done with the most efficient possible transfer of capital. Put another way: It is one thing to remove a dollar from a social program and to guarantee its use for rebuilding the country's industrial base. It is quite another thing to transfer this dollar to a third party with the expectation or "hope" that part of it will be used for its intended purpose. The second way cheats the poor and hardly qualifies as "supply side" in any serious way. Yet this is the effect of the present tax scheme.

2. Reducing capital gains taxes across the board is similarly inefficient, because it fails to discriminate between productive, secondary, and unproductive investment, and even rewards some forms of investments which many would view as socially counterproductive, notably real estate speculation.

3. The notion that increasing the level of savings will automatically result in massive productive investment is also largely fallacious. It may do so under certain conditions. However, the financial choices available to banks and savings institutions are similar to those available to individuals. If T-bills are rationally preferred by individuals, then they will be preferred by banks and institutions. Hence, in the present climate it is possible to have adequate savings yet still have stagnation of the "supply side".

4. An additional virtue of my proposal is that there would be much less delay in its effect than under the current scheme. Deficits would not have to be created in the hope that they would eventually produce a business surge (a business slump is more likely, in my opinion, because of the resultant high interest rates). If, in addition to enactment of my proposal, a rescission of excessive tax cuts could be obtained, and also a 3% VAT together with a $5 tax per barrel on imported oil, it is entirely possible that the budget could be balanced immediately. The immediate effect would be to reduce interest rates to moderate levels. The bias toward productive investment contained in my proposal would then begin to take effect, and the country might well be on the road within a few years to a reinvigorated capital plant without any inflationary side-effects.

It has been my pleasure to be of service to the committee.

Yours very sincerely,

Glenn R. Manacher

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November 13, 1981

Mr. William R. Buechner
Senior Economist
Joint Economic Committee
Washington, D.C. 20510

Dear Mr. Buechner:

I wish to add some remarks of a summary nature to my letter of October 1.

First, it now appears that several members of the President's Council of Economic Advisors do not believe that the recently enacted tax cuts will have any significant effect on investment.* This may, and probably does, include Mr. David Stockman, who has stated privately that the primary purpose of these tax cuts was to restrain Congressional spending.

Second, it is clear that the Japanese technique for market penetration is to make capital available directly for long-range investment in industries whose modernization appears worthwhile. This is done mainly by making loans available at artificially low interest rates. Such loans are really a subsidy.

My plan can be looked at as a way to make comparable investment available to American businesses.

Third, according to Felix Rohatyn, massive outflow of American capital, chiefly for energy, will soon result in OPEC's having enough cash to buy out half the companies on the New York stock exchange. Failure to modernize now may make it almost impossible later without giving up domestic ownership.

Fourth, and perhaps most importantly, the grim prospects for control of population, management of resources, and even global stability envisaged by the encyclopedic report "Global 2000: Report to the President" must and will interact with the American economic engine. No one knows precisely when, or with what sequence of effects. The time scale, again, is on the short side: on the order of twenty years. This fact alone indicates how urgent a task it is for our government to create a focussed and credible policy for ensuring massive capital investment. The alternative policy of redistribution of wealth to the rich and inert expectation of a fallout miracle betrays a torpor surprising in an administration that claims to embrace an activist conser-

*Private communication from Mr. Ben Weberman of Forbes magazine.

vative philosophy.

Fifth, it is clear that most primary capital investment pays off only after a five to ten year delay (the Japanese use ten years as a benchmark). Therefore the Reagan Administration's counting on a reflow from the recent tax cut to help balance the 1984 budget is utterly unrealistic. Such a reflow -- if it occurs at all -- will come not from primary investment, but rather from increased churning of secondary and unproductive markets, quite likely at the expense of the primary investments the tax cut was supposed to stimulate.

James Chace has identified solvency as the key to our vitality as a nation. Since the beginning of the Viet Nam war, our solvency has been eroding. I hope that my report will be of help in reversing the drift.

Yours very sincerely,

Glenn K. Manacher

Glenn K. Manacher
Associate Professor

GKM/ct