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Tax, Trade and the Technological Revolution, Information Technology Association of America

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Senator Max Baucus
Information Technology Association of America
Washington, D.C.

June 27, 1996

Good afternoon, everybody. Thank you for inviting me to speak with you today.

We are here to talk about tax policy and its effect on the information industry. Your program includes national tax reform proposals and specific issues like taxation of the Internet and prospects for the R&D tax credit.

I am happy to discuss them with you, but I want to start with something different. I'd like to put these policy issues in a broader context -- the meaning of the technological revolution for individual Americans and our country as a whole. And when we've done that, the policies fall into place more easily.

THE TECHNOLOGICAL REVOLUTION

To open with a platitude, we live in an age of change. In politics, the end of the Cold War. In economics, the boom in East Asia and the growth of international trade. But the most profound change of all is the scientific and technological revolution.

Its commercial implications alone are staggering. Software companies which did not exist thirty years ago now create $130 billion in wealth, grow by 28% a year and employ two million Americans. Semiconductor companies, computer manufacturers and telecommunications firms can tell similar stories.

This sort of growth has happened only twice in our history -- with mechanized textile production in the early 19th century, and Henry Ford's automobile industry eighty years ago. And now as then, the economics are actually less important than the changes in our daily lives.

On the job, assembly lines and low-skill workers have given way to automated factories, and typists to computerized printers.

At home, middle-class families have more consumer goods than ever before, from telephones which automatically dial the police to report fires and break-ins, to PCs and movie-size television sets.

Meteorologists predict hurricanes weeks in advance. Civil engineers plan roads that get
you to work more quickly and safely. Architects can design buildings that are wider on the top than the bottom. Students share notes with their colleagues all over the world. Manufacturers improve the quality of their goods.

The changes in health and medicine may be the most dramatic of all. One of my staff members recently had a nephew born without fully developed lungs. In the past, this baby would not have survived. Today doctors can place him in an artificial amniotic solution, whose chemical contents and oxygen level are controlled by computer, and give the lungs several more weeks to grow. Their main worry is the child will have asthma.

EFFECT ON JOBS AND WAGES

Virtually everyone benefits in some way from the technological revolution. But nothing of this magnitude can be an unalloyed good. Some of us also suffer from it.

As computers and robots replace assembly lines, unskilled labor pays less well. People without a college degree find it hard to earn a living wage. And income differences become sharper all the time. Lester Thurow highlighted this problem in The Zero Sum Society in the late 1970s, and it has only worsened since then.

Jobs are affected too. While our manufacturing production has nearly doubled since 1970, we have not added one new manufacturing job. We had 20 million then, and we have just a bit fewer today. You can see the reason if you visit a northwest Montana timber mill. Fifteen years ago, these mills used twelve workers to guide a log along the assembly line. Today, they use a laser eye to stabilize the log, and employ only four workers on the line.

Because of this, many Americans no longer can find a job that pays enough to raise a family. Crime, family breakdown, and the sense of lost community from which our country suffers stem at least in part from this fact. And unless we address it, these problems will get worse -- because very soon, a person who cannot operate a computer will not just work for low pay, but will be unemployable.

EDUCATION

So that is the broad context in which we should form our tax, trade and other policies. And it presents us with two challenges.

One, we need to address the difficulties less educated workers face. It would be wrong and it would hurt the country if new technologies made some of us fall behind.

And two, America is a nation that takes pride in being a leader. And most of us would like our country to remain a leader.

In principle, if not in practice, the right answer to the first challenge is easy. We need
to improve education. Make sure all our children are familiar with modern technology. Make sure they all have the chance for a college degree.

That is why the new Congress was wrong to try and cut the student loan program. And it is why we should use the tax code to encourage education. We should permanently extend the Section 127 education exclusion. And we should create a new tax deduction to help families pay college tuition.

TECHNOLOGY AND NATIONAL POWER

Responding to the challenge new technologies pose to our world leadership is a bit more complicated -- because we start from a strong position, and the question is how we preserve it.

Like most Americans, I am a bit nationalistic. I like the idea of the United States as the world leader. And I know that our ability to lead the world depends on a strong economy.

At our industrial peak, when Europe and Japan were rebuilding from World War II, we produced half the world’s GDP. Today we are between a quarter and a fifth. An economist would say -- correctly -- that this is only a relative trend, which does not affect the well-being of any individual American. But most of us are a little unhappy about it nonetheless.

But information industries have the potential to reverse the trend. In these industries, we have surpassed even our postwar industrial peak. We produce 75% of the world’s software, for example, and employ nearly half the people in the world who create it. And at some point, the growth of information will mean more than GDP growth in determining economic power.

So if we believe national power and leadership is important, we should strengthen our scientific and technological leadership rather than allow it to erode. That means a sustained government commitment to research and development. And it means international trade and tax policies which make us more competitive.

COMMITMENT TO BASIC RESEARCH

Let’s begin with research. I recently got a letter from sixty American Nobel Prize winners in chemistry, physics, medicine and economics who are concerned that the Congress may reduce its support for research and development in the belief that the private sector will take care of it all. As they put it:

"Discoveries are rarely made instantaneously, but result from years of painstaking work by scientists in a variety of fields. With competition forcing industry to focus research investments on returns over the shorter term, the government is left with the crucial role of making the longer-term investment in discovery."

The computer itself is a case in point. The first computer -- the ENIAC, or "Electronic
Numerical Integrator and Calculator" -- was designed in 1944 and went on line in 1946. It was not built by companies that saw a business opportunity, but by scientists at the University of Pennsylvania, with a $540,000 grant from the Army.

The builders of ENIAC and other early machines were scientists of true genius. But they did not foresee the future, and did not pretend they could. The computer pioneer Alan Turing, reporting to the British government in 1945, said his proposed machine could calculate range tables for field artillery and "count the number of butchers due to be demobilized in June 1946." He thought it might also solve jigsaw puzzles.

There was no commercial use of computers for nearly a decade. Other technologies, from radar, to e-Mail, the Internet and pest-resistant strains of wheat, went through the same evolution. A small government investment in basic research paid off many-fold.

Today, some still say government support for new technology, from SEMATECH to the Advanced Technology Program and the Environmental Technology Initiative, are too expensive or tread in areas we should reserve for industry. For example, while the OECD reports that the world market for environmental technology will reach $300 billion by the year 2000, the House wants to cut support for enviro-tech research to zero. I think that's a big mistake. This is one of the world’s fastest growing markets. And it is a field where science is advancing rapidly. We need to be a leader in it, just as we do in software and other strategic technologies.

It is just as the Nobel Prize winners say. We may not know what precisely is coming. But we know there will be scientific breakthroughs and revolutionary new commercial applications for them. And I would like it to happen here.

R&D TAX CREDIT

That is also why the research and development tax credit is so important. Some think it is too expensive. But I think it would cost us more to abandon it. Most industrial countries already give research better tax treatment than we do, and for good reason. They want to catch up, and they know new high-tech products depend on research.

We tend to think of the information industries in terms of the largest players -- Microsoft, IBM, Sun, Intel, Oracle and so on. But most software companies are small outfits, which rely on one or two specialized programs for most of their revenue. It costs a lot to develop these programs. The R&D tax credit helps many small firms get a start, and helps all companies look to the future. It is a good investment.

So I am happy we got the Finance Committee to take a first step toward renewing the R&D tax credit for another year. I still want to see it reinstated retroactively to last year. But under the budget rules we need about $1.9 billion in new revenue for that, to offset lost tax revenue and avoid raising the budget deficit. That's a lot of cash -- but I think we can find it and get the job done.
FSC REGULATIONS AND TRADE POLICY

Then let’s look at trade, because it is at least as important to sell products as to invent them. As tax experts, you may know that the Constitution forbids only one kind of tax. Under Article I, Section 10:

"No Tax or Duty shall be laid on Articles exported from any State."

That is an unusual clause. The Framers, with the failure of the Articles of Confederation in mind, did not like giving up any potential source of revenue. And their decision to renounce a tax on exports reflects a profound judgment on the importance of foreign markets.

Our Foreign Sales Corporation statute follows this up in a small way, providing a tax incentive for film and recording artists to export. But Treasury’s regulations for FSC exclude software. As far as I know, the FSC regulations are the only American trade or copyright policy which discriminates between software and other copyright works. It makes no sense.

But I have tried since 1987, through three Administrations, to get the Treasury Department to change its mind, and they haven’t done it. So we probably need a legislative fix. Under our budget rules, that requires about $700 million over ten years. We found it when the Finance Committee drafted its small business tax package this month, but the Committee in its wisdom decided not to include any "foreign" tax provisions. So we’re not there yet, but we’re getting closer and I’ll keep at it.

At the same time, of course, export promotion is just half the policy. We also need to keep opening markets, among other things by renewing our Semiconductor Agreement with Japan. And we need to keep fighting piracy, because computer programs are almost the ideal temptation for pirates. They are high-value products. They are difficult and expensive to develop. And they are cheap and easy to copy. We need to use sanctions if necessary to stop it, as the Administration has just done in China.

SECTION 956A

On the subject of trade, I should mention section 956A. This was intended to treat domestic and foreign investment more equally. But as happens every so often, it created a perverse incentive that favors foreign investment over domestic investment. And when Congress makes a mistake, it should admit it and fix the problem.

The House recently voted to repeal it, to their credit. But the Finance Committee did not include language repealing 956A in its small business tax bill, and the full Senate probably won’t either. That is because bringing up any international tax provision on the Senate floor would raise Senator Dorgan’s foreign investment bill.

I don’t think that bill is especially good policy, but it is popular. It nearly passed when
the Senate voted on it last fall. And with an election four months away, it's impossible to say what would happen now. So the leadership is unlikely to address 956A on the floor, and you should look to the conference committee.

SECURITIES LITIGATION AND DEPRECIATION

Finally, we can take common-sense domestic policy measures that help companies invest and look to the future.

One was the securities litigation bill we passed last year. This is already paying off. Several companies already report that the premiums they pay for directors and officers' insurance are down anywhere from 10-15%. That means more capital for investment, especially in newer start-up companies; and ultimately more new products and a more competitive industry.

A longer-term project is revising the depreciation schedules which apply to the high-tech sector. We developed these schedules for older, more established industries. And we need to change them to reflect the useful life of information industry technology. Semiconductor manufacturing equipment almost completely loses its ability to produce vendable products after three years. We should make sure our depreciation schedule reflects that, as competing nations like Japan, Taiwan and Korea already do.

That's probably a long-range goal. This Congress has only a few months left, and its very partisan atmosphere makes it hard to accomplish anything at all. We have to pick our fights carefully.

CONCLUSION

And that brings me to my last point. When we talk about the fine points of tax legislation -- whether it is tax deductions for education, or the R&D tax credit, or the FSC regulations -- we are really talking about ways to get at the deeper issues.

Helping citizens prosper in an age that demands new skills.

Making businesses more competitive.

Keeping our country a world leader.

These are profound questions. I have strongly held ideas about them. But I also know that neither I nor anybody else -- in academia, business, government, or either political party -- has a monopoly on wisdom.

The more we listen to one another and work together, the more likely we are to find the right answers.
Too often in Congress, people get wrapped up in the partisan battle of the day and forget that fact. That’s only human. But we should also remember that we all make some mistakes. We all have some good ideas. And we’re all in this together.

If we do that, I think we’ll do just fine.

Thank you.