

OUTLINE OF REMARKS

MCDERMOTT, INC.

May 5, 1982 - 7:00 p.m. - Madison Hotel - *Wash. D.C.*

I. The Budget--Need for Swift Action

A. Negotiations to Date

1. While bipartisan budget discussions have not produced an agreement, they did help us sort out how much room there is for compromise. The 'gang of 17' did come very close: a few sticking points remained on revenues, on keeping the third year of the tax cut out of bounds, and on the scope of domestic spending cuts. Nevertheless it is clear that there is substantial agreement in some areas, and we should work to expand on that to cut the deficit as much as possible.
2. The process of negotiations has made it clear that the cause of deficit reduction is more, not less, urgent. The President agrees with that--the Senate agrees with that--the Speaker agrees with that. That is why, despite differences, there is still reason to be optimistic that we can work out an agreement to tackle the red ink this year.

B. Role of the President

1. The President did send up a 1983 budget that lacked support in Congress because it is open to the charge that it does not share the burden of deficit reduction in an equitable way. Nevertheless, that budget remains the only official, coordinated plan for reducing the deficit in a credible way.
2. Since most in Congress want an alternative budget, we have to get on with that task. But the President has helped by acknowledging our concerns and moving to support our efforts at deficit-reduction: even though that meant agreeing to actions that he sees as inconsistent with his tax cutting philosophy.
3. The President has made his effort and proven his good faith by acknowledging the scope of the deficit problem and moving to support a bipartisan agreement.
4. The President stresses maintaining the fundamentals of his program, but there are many ways to increase revenues, deal with entitlements and appropriations, and moderate defense spending without sacrificing

I. The Budget--Need for Swift Action

A. Negotiations to Date

1. While bipartisan budget discussions have not produced an agreement, they did help us sort out how much room there is for compromise. The 'gang of 17' did come very close: a few sticking points remained on revenues, on keeping the third year of the tax cut out of bounds, and on the scope of domestic spending cuts. Nevertheless it is clear that there is substantial agreement in some areas, and we should work to expand on that to cut the deficit as much as possible.
2. The process of negotiations has made it clear that the cause of deficit reduction is more, not less, urgent. The President agrees with that--the Senate agrees with that--the Speaker agrees with that. That is why, despite differences, there is still reason to be optimistic that we can work out an agreement to tackle the red ink this year.

B. Role of the President

1. The President did send up a 1983 budget that lacked support in Congress because it is open to the charge that it does not share the burden of deficit reduction in an equitable way. Nevertheless, that budget remains the only official, coordinated plan for reducing the deficit in a credible way.
2. Since most in Congress want an alternative budget, we have to get on with that task. But the President has helped by acknowledging our concerns and moving to support our efforts at deficit-reduction: even though that meant agreeing to actions that he sees as inconsistent with his tax cutting philosophy.
3. The President has made his effort and proven his good faith by acknowledging the scope of the deficit problem and moving to support a bipartisan agreement.
4. The President stresses maintaining the fundamentals of his program, but there are many ways to increase revenues, deal with entitlements and appropriations, and moderate defense spending without sacrificing

those fundamentals. The margin of compromise that is available ought not to be allowed to slip away.

C. The Congress

1. The congressional leadership has begun a concerted effort to find a bipartisan solution to the budget problem. That is only right: we would be reneging on our responsibilities if we did otherwise.
2. Even so, Congress cannot evade the fact that it is the source of the main problem--the uncontrolled growth of Federal spending in recent years. That spending momentum, aggravated by past inflation and current recession, is the cause of the record deficits now projected.
3. Congress is obliged to come up with concrete alternatives. Discussions to date indicate there is at least agreement that we need a package that tackles all aspects of the deficit problem: appropriations, entitlements, revenues, and defense. The package must be balanced and fair.
4. The debt ceiling remains the only action-forcing deadline on the agenda. That means we ought to be prepared to act in May to avoid bumping against that ceiling.

II. The Economic Recovery Program

A. Sticking to Fundamentals

1. The concern about threatened deficits is nearly universal, and it is justified. But the deficits are not a result of the Reagan program, but of deep-rooted economic problems, some of which were underestimated by the administration. But we have to follow through on the administration's fundamentally sound principles of spending reduction, lower taxes to restore incentive, a firm but fair monetary policy, and a strong defense.
2. We must aim at sustaining recovery after the recession. That is what the debate is all about. No one advocates tax increases or further 'drag' on the economy while recession persists.
3. Significant progress is being made on the economy. Inflation in 1981 dropped to 8.9%, the lowest since 1977. Producer prices dropped in both February and March, and in March the CPI declined by three-tenths.

of a percent--the first such decline since 1965, and the largest drop since 1953. This is dramatic progress on what everyone considered to be our number one economic problem.

4. Interest rates remain too high, but they have come down. 16 1/2 percent is better than 21 percent, and there is reason to expect a continuing, if gradual, downward trend this year. Cooperation between the President and the Congress will bring rates down faster, by showing a firm course: controlling spending, reducing deficits, and pursuing tax policies that encourage work, savings, and investment.

B. The Recession

1. The recession is the reason our problems are more acute than anticipated. It has driven down revenues in the short run (lower inflation and slower growth) but has a lagged effect on slowing spending, while in the near term unemployment and related costs increase.
2. In 1980 the Carter administration tried to prime the pump after experimenting with monetary restraint--the subsequent clampdown proved that the "recovery" from that recession was a false one. Only now are the full effects of that same recession being felt. The important thing this time is to ensure a sustained, real recovery.
3. Compounding the problem are the declines in autos and housing. But those are deep-rooted problems, partly a result of the rampant inflation of recent years and partly due to inconsistent policies on energy, taxes, and productivity. The Reagan administration is beginning to make progress on these problems--we now see harder bargaining in labor negotiations that may lay the basis for a more rational industrial policy.
4. Major shifts in policy are bound to bring instability as we make the transition, particularly when we are moving out of a period of double-digit inflation. But the only alternative is inflation and stagnation. Dealing with the deficit is the best way to get things back on an even keel.

III. Options Before Us

A. Basic Principles

1. We cannot proceed without parameters--guidelines. The sooner we narrow the range of options, the better.
2. We cannot, for instance, allow the need for revenue increases to justify uncorking the spending bottle. Too often Congress has used tax increases to spend more, not cut the deficit.
3. For the same reason the individual tax cut should be kept out of bounds. It is mainly an offset for bracket creep, and we do not need further resort to the inflation tax as an excuse to avoid responsible budgeting.
4. Defense spending must increase, but perhaps it can increase at a slower pace by balancing our urgent defense needs against longer-term priorities.
5. Spending must be brought down--there is no other way to get a handle on the deficit. That means entitlements and so-called uncontrollables have to play a role.

B. Revenues.

1. There are several ways to proceed: the President proposed management changes, user fees, and some loophole closings. All of those will play a role, and they should in the interest of ensuring everyone pays a fair share of taxes.
2. Likely candidates for action include corporate and individual minimum taxes, reductions in the safe-harbor leasing provision of the 1981 tax act, and efforts to narrow the compliance gap in the income tax--as in the Dole-Grassley bill, S. 2198.
3. Another option, consistent with the goals of individual rate reductions enacted last year, would be to accelerate tax indexing to July 1, 1983, in place of the 1983 rate cut. Lower inflation means less rate reduction than we anticipated is needed to offset bracket creep. If the inflation trend continues, this option could bring marginal rates to about where they were expected to be when we passed the tax bill, yet raise about \$17 billion over two years.

C. Entitlements.

1. Reform of basic entitlement programs is needed to bring the budget in line. Administration proposals for 1983 would save about \$52 billion over 3 years. We should try to meet or exceed that figure.
2. Partly due to cost-of-living adjustments, entitlements (other than social security) rose 412% between 1970 and 1981. We cannot sustain that kind of growth.
3. As an example, Medicare is expected to cost \$50 billion in 1982, and Medicaid \$32.5 billion. Hospital cost rose 18.6% between October 1980 and October 1981. We cannot afford this rate of increase, and must consider reforming reimbursements, more private sector options, and greater competition in the health care industry.
4. COLA's must be reconsidered, even in the social security area. In the 1970's social security cash benefits grew at a pace of 14.2% each year. That is cause for concern. Real savings can be made consistent with keeping social security recipients on a par with wage earners in our society. For example, moving to a 2/3 CPI adjustment could save as much as \$5.4 billion in 1983, \$50 billion by 1986.

IV. Some Perspective on Our Situation

A. A Growing Economy

1. By 1986 the administration expects the economy to grow from \$2.8 trillion to \$4.6 trillion. Such growth means a better ability to finance our defense needs and critical social programs, without taxing the life out of the economy.
2. If we have slower growth, then we have to reexamine our options. CBO and the administration are in basic agreement on economic trends: this is the time to strike a prudent, but optimistic, balance. But clearly \$100+ billion deficits are unacceptable, economically or politically.

B. 1981 Tax Act and the Deficit

1. The 1981 Tax Act, though the largest tax cut in history, just stabilizes the tax burden. Revenues still will rise from about \$600 billion in 1981 to about \$800 billion in 1985. Receipts by 1987 should

be 18.7% of GNP--the same as the average between 1963 and 1973. Without action, receipts would have been a crushing 24% of GNP in 1987.

2. The question is how high a deficit can be tolerated without "crowding out" or threatening a resurgence of inflation. Increased savings due to tax changes and the drop in inflation should ease pressure in financial markets. We must do more to ease that pressure without undermining the economic program.
3. Many provisions of the tax act aid capital formation and innovation: R & D tax credits, capital gains reduction to 20%, IRA and other savings incentives. These coupled with rate cuts and accelerated depreciation, form the framework for regeneration of business activity.

V. Future Agenda for Tax and Fiscal Policy

A. Revenues

1. Thrust of future tax legislation will be to eliminate abuses and obsolete incentives and improve tax administration and collection. The 1981 Tax Act shows this trend, as in closing the commodity straddle loophole.
2. The administration proposes raising over \$30 billion over 2 years by tightening in these areas, and by new enforcement devices. Depending on the size of spending cuts we can agree to, Congress may want to increase this figure.
 - Completed contract method for multiyear defense contracts. (\$6.3 billion over 2 years.)
 - Cut back business credits that duplicate conservation efforts of decontrol (\$.4 billion over two years). (Congress is not sympathetic to this).
 - Industrial development bonds (restrict, require matching efforts from State or locality, etc.) (\$0.1 billion over two years).
 - Eliminate insurance industry loophole (modified coinsurance). (\$4.1 billion over two years).
 - Capitalization of construction period interest and taxes. (\$1.5 billion over two years).

3. Underground Economy

a. The Compliance Gap

The IRS estimates that \$100 billion is lost annually though noncompliance with the federal income tax laws and that amount will rise to \$133 billion by 1985.

b. The Proposal

S. 2198, the Dole-Grassley bill, would improve the current system of information reporting. A companion bill has been introduced in the House by Representative Barber Conable. 9 to 16% of interest and dividends paid go unreported. We can improve the reporting system by including federal debt and bearer obligations and impose real penalties on those who refuse to comply.

c. The Administration

The administration has proposed 5% withholding--an option that we cannot rule out, but that has been unpopular. All aspects of noncompliance, including, for example, underreporting of tips and capital gains, may be addressed by better information reporting. The administration supported S. 2198 at hearings held on March 22.

d. Coverage

In addition, new penalties would hit the sophisticated tax avoider and the fraudulent corporate tax manager. The interest rules would be revised to reduce current incentives to defer paying taxes.

e. Revenue Effect

The legislation is expected to generate about \$3 billion in 1983, \$8.1 billion in 1984, and \$9.3 billion in 1985.

4. Minimum Tax

a. Current Law

Current law includes three very complex minimum taxes, two on individuals and one on corporations. These taxes raise only \$1.5 billion and still permit significant numbers of taxpayers to pay no tax.

b. Administration Proposal

The Administration would address this problem by creating a new alternative minimum tax on corporations. This would raise about \$2.3 billion in the first year, rising to the \$4 billion range.

c. The Dole Proposal

The proposal being considered would completely revise and simplify the minimum taxes. In lieu of the overlapping alternative and add-on taxes on preference items, the minimum taxes on corporations and individuals would be a flat rate of, perhaps 15% on a comprehensive, economic income base.

d. The Tax Base: Individuals

Included in the tax base for individuals might be adjusted gross income and items like excess accelerated deductions, contributions to IRA's and Keoghs, the stock option preference, intangible drilling costs, certain excluded items and other items.

e. Corporations

Corporations' tax base will begin with taxable income and add-back similar preference items of accelerated depreciation, certain deferred income, and excluded items. Of particular interest to banks is a rule which disallows interest deductions to the extent that tax-exempt instruments are included in a bank's investment portfolio.

f. The minimum tax is fully consistent with the 1981 tax cut. That tax cut provided incentives by reducing marginal tax rates. The marginal tax rate of a minimum tax will only be 15%: all

taxpayers with substantial real income ought to pay some income tax.

g. Revenue Effect

The proposal is tentatively expected to produce approximately \$2 billion annually from the individual tax and \$6 billion annually from the corporate tax.

5. Leasing

- a. Some revenues may be generated by cutting back on the safe-harbor leasing provisions of the 1981 Tax Act. Those provisions are now expected to cost about \$30 billion over six years, and the figure may go higher when Treasury analyzes its reports on leasing transactions.
- b. Possible options, aside from outright repeal, include offsets in other tax preferences, application of strengthened minimum tax, or direct limits on tax sheltering.

C. Social Security

1. We have restored the minimum benefit and authorized temporary interfund borrowing. Now the President's Task Force, chaired by Alan Greenspan, is preparing to address the long-term problems of social security. Some action may be necessary before the Task Force completes its work.
2. Only if the economy performs considerably better than in the past 5 years could social security remain solvent beyond 1984 or 1985. Even then:
 - Under the most recent projections by the Social Security Board of Trustees, the combined reserves of the system fall dangerously low (below 14 percent of outlays) in 1985. The system would be unable to pay benefits beyond 1987 (when reserves fall below 9 percent of outlays).
 - Under more pessimistic economic assumptions--more like recent experience--social security would be broke by late 1983.
3. The trust funds already are seriously depleted--reserves equal 23 percent of outlays or barely 2 to 3 months' worth of benefit payments. The history of

the trust funds indicates that reserves equal to 100 percent or more were the norm prior to 1970.

4. Further tax increases, beyond those legislated in 1977, are not the solution. The long-term cost of social security must be brought into line with taxpayers' willingness and ability to pay for it.

V. Enterprise Zones

1. The President also wants to establish enterprise zones to benefit from targeted tax incentives and, hopefully, Federal, State, and local regulatory relief. The notion of unleashing free enterprise makes sense: but there are difficulties.
2. There is a risk that zones may put businesses outside the zone at a competitive disadvantage. We do not want to drain business activity from the periphery of zones.
3. Shifting economic resources around would not be enough. We ought to have some assurance that new activity is likely to be generated.
4. The selection of zones--if limited to 25 per year for three years, as proposed--will be a touchy matter. If it is to have any meaning, this should be an experiment in free enterprise, not a new pork barrel.
5. The President's proposal includes a new 10% investment tax credit for construction or rehabilitation of commercial, industrial, or rental housing structures within a zone. This could help meet housing and commercial needs in depressed areas.
6. Primary emphasis must remain on the general economic growth we need to create jobs across the land.

VI. Summary--Where We Are Now

- A. A Watershed Year. The recession makes this a tough year for Congress and the President. There are no easy or palatable options available. That means we have to establish our priorities swiftly but with care: not an easy task. But if we show that we can work together to deal now with problems that have been building over many years, we will have a major breakthrough in favor of economic recovery.
- B. Shared Effort. The economic problem can only be addressed by a joint effort all around--Congress and the

President, Democrats and Republicans. Those who would seek partisan advantage from our economic dilemma are mistaken. If we hang, we all hang together, regardless of party. The people will not care who prevented action, if nothing is done. What we need are results.

DS:a