Oct. 7

United States Senate
COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

October 6, 1982

TO: Senator Dole

FROM: George Pieler

SUBJECT: Evans & Novak Forum

Attached is a copy of the current Outline of Remarks that you may want to use for the Evans-Novak Forum Thursday morning, October 7.

I spoke to Rowland Evans on Monday and he indicated you would have 10-12 minutes for remarks, as would Jim Wright, followed by questions and discussion. Specific topics Evans and Novak hope to have covered are:

(1) Budget and taxes: how can we avoid future tax increases?

(2) Will the GOP stick together, or is the right wing heading for a break?

(3) Social Security

(4) Your prognosis for the November election.

Also attached is a description of current CBO deficit projections.

Attachment

CURRENT CBO BUDGET DEFICIT ESTIMATES
(September 1982)

FY 1982 $112 billion

FY 1983 $155 billion

FY 1984 $152 billion

These higher deficits compare with those projected under the 1983 Budget Resolution, which are as follows:

FY 1982 $106 billion

FY 1983 $104 billion

FY 1984 $ 84 billion

The increased deficits now projected by CBO (still assuming that the 1983 budget resolution is fully adhered to) are the result of:

- lower revenue projections, mainly due to slower growth ($26 billion less in 1983, $37 billion less in 1984)

- Higher spending estimates, primarily from technical reestimates (total of $18 billion more in 1983)

Note: lower inflation also is a major factor reducing revenue expectations. CBO now projects inflation around 6.4% in 1983 (GNP deflator) rather than 7.3% as formerly projected; 6.1% in 1984 as against the 6.6% projected under the budget resolution.

Growth rate: CBO now projects real GNP to grow at a 3.6 percent rate in 1983, as compared with the Budget Resolution assumption of 4.5 percent. This, if anything, is the major factor in explaining the higher deficit projections). Real GNP in 1984 is now projected at 3.7 percent, rather than the 4.1 percent under the Budget Resolution assumptions. Clearly, the faster interest rates drop in line with inflation, the better chance there is of faster growth: the best solution to the deficit problem, but not one that can be predicted with any certainty at this time.

OUTLINE OF REMARKS

EVANS-NOVAK FORUM

October 7, 1982 - 8:30 a.m. - Madison Hotel

I. The Budget--Major Progress and Continuing Need for Action

A. The Congress has taken important steps to implement our budget agreement: the Finance Committee and Budget Committee reconciliation bills have become law. Now that we have begun to take substantive action on the deficit, the need to maintain control over fiscal policy is more urgent than ever.

B. The President led the fight for the tax reform and spending reduction bill because he knew it would preserve the fundamentals of his program and increase the prospects for lower deficits and lower interest rates, which are crucial for recovery.

C. Congress now has to follow through to implement every part of the budget agreement. Spending has to be brought under control, and appropriations bills we take up in the post election session will have to be kept in line with the budget resolution to complete our deficit reduction efforts. That is the only way to act in good faith with our citizens and insure the confidence of the financial community.

D. The reconciliation bill that originated in the Finance Committee includes the largest single spending reduction passed this year, about $17 billion. It also raises $98.3 billion in revenues from improved compliance, eliminating obsolete tax incentives, insuring that everyone pays their fair share, and modest excise taxes and user fees.

II. The Economic Recovery Program

A. Sticking to Fundamentals

1. 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, because they are crucial to a long-range recovery strategy.

2. We are aiming at sustaining recovery after the recession. That is what the debate is all about. No one advocates further "drag" on the economy while recession persists.

3. Significant progress is being made on the economy. Inflation in 1981 dropped to 8.9 percent, the lowest since 1977. Inflation is running at a 5 or 6 percent rate, in March the CPI declined by three-tenths of a percent--the first such decline since 1965, and the largest drop since

1953. In August, inflation was running at a 3 1/2 percent annual rate. 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. 13 1/2% is far better than 21 percent, and there is reason to expect a continuing, if gradual, downward trend this year.

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 insure a sustained, real recovery.

III. Tax Reform Package

A. Many people are perplexed at the fact that we are raising new revenues this year, when we passed a tax reduction program last year that was supposed to restore certainty to the tax laws. The budget deficit problem is one major reason for the shift, of course: but our tax reform bill makes changes that are needed irrespective of the deficit problem. They are needed in the interest of fairness, simplicity, and economic efficiency.

B. We can get more revenue out of the present tax code. By improving compliance--which has dropped off in recent years because of inflation, high marginal rates, and the proliferation of special tax privileges--the tax reform bill raises about $28 billion over three years. By cutting back on the inefficient safe harbor leasing provision, we raise over $8 billion. And we cut back many other loopholes and preferences that no longer serve an important purpose, and which should be cut back or eliminated: tax breaks for self-employed pension savings, industrial development bonds, and insurance industry loopholes.

C. We reached a consensus to concentrate on improving our tax laws before we slap on new taxes. This is the approach President Reagan endorsed, because it is fair and it preserves the tax cut for working people. Everyone must pay a fair share of tax: it is hard to justify new taxes, or cutting back the individual tax cut, unless we deal with the special exceptions that turn our tax base into Swiss cheese.

D. Out of our tax package, all but $15 billion to $20 billion comes from tax reform and compliance measures. The rest comes from modest excise taxes and user fees, and taxes associated with particular government benefits.

IV. The 1983 Tax Cut

A. A number of Senate Democrats persisted in trying to pare back the 1983 tax cut to raise revenue because that is "the path of least resistance." The President disagrees, and I disagree. That cut is needed to help American workers--it is needed to offset bracket creep and payroll tax hikes. And it is a firm promise we made to the American people.

B. Who is helped. There has also been a lot of criticism of the individual tax cut on the grounds it helps the rich at the expense of the average worker. But the American people want to keep their tax cut. In any event, the "rich man" allegation is false. 36.6% of the 1983 cut goes to people with incomes between $20 thousand and $30 thousand. 53.7% of the tax cut goes to Americans earning $20 thousand to $50 thousand. 70% goes to those under $50,000.

C. In addition, it is worth noting who would be hurt worst by tampering with the third year. The group whose tax liability would rise the MOST is that $20-$30 thousand income class--in other words, the average working American. If this is a rich man's tax cut, explain it to the working man.

V. 1981 Tax Act and the Deficit

A. 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 after the 1982 tax bill, should be about 19.4 percent of GNP--close to the average between 1963 and 1973. Without action, receipts would have been a crushing 24 percent of GNP in 1987.

B. 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 continue to do more to ease that pressure without undermining the economic program.

C. Many provisions of the 1981 tax act aid capital formation and innovation: R. & D. tax credits, capital gains reduction to 20 percent, IRA and other savings incentives. These coupled with rate cuts and accelerated depreciation, form the framework for regeneration of business activity.

D. Tax Indexing. Indexing is the major tax reform of 1981, and it is here to stay. It is also the most progressive change, and the most meaningful for working Americans. Indexing just means that Congress is accountable for tax increases--we cannot rely on tax inflation to keep the budget afloat to the tune of $1.7 billion or more per point of inflation. In Senate consideration of the budget resolution we defeated a move to repeal indexing by 56-34. Repealing tax indexing would risk signaling we intend to reinflate the economy.

E. Major Benefits in ERTA. With the talk about deficits and tax increases, some have lost sight of the major tax relief and incentives we provided in the 1981 tax cut.

1. Marriage penalty relief. A 10-percent deduction for the lower earning spouse's income eases the tax burden on working couples.

2. Estate tax relief. The credit against estate and gift tax will rise to $600,000 by 1986: this will free many small- and medium-size family estates from any tax, and greatly reduce the burden on all estates. An unlimited marital deduction forever eliminates the "widow's tax"--there is no tax now on transfers between spouses. In addition, special use valuation for farm property was greatly expanded, easing the burden on family farms; and the maximum estate tax rate drops from 70 percent to 50 percent over 4 years.

3. IRA incentives. Every taxpayer can now deduct up to $2,000 per year in contributions for individual retirement. This helps the small saver, can help boost the savings rates, and eases pressure on other private and government retirement programs.

4. Other provisions that provide significant help to the individual taxpayer include an expanded child care credit, an increase to $125,000 of the amount of gain on sale of a principal residence that can be rolled over, tax relief for Americans working abroad, and a charitable deduction for all taxpayers, regardless of whether they itemize. For the first time in years we have a strong pro-taxpayer policy in Washington--that will not change, even though we are obliged to raise significant revenue in the short term to deal with the deficit. Our goal is to maintain tax relief over the long term and improve the fairness of the tax code.

VI. Future Agenda for Tax and Fiscal Policy

A. Revenues and Major Items in Our Tax Reform Package

1. Thrust of future tax legislation will continue to eliminate abuses and obsolete incentives and improve tax administration and collection, which should facilitate further reductions in tax rates. The 1981 Tax Act began this trend, as in closing the commodity straddle loophole,

and this year's Tax Equity bill is a major step forward in terms of tax fairness.

2. Last September the administration proposed tightening in these areas, and by new enforcement devices. Many of these provisions are included in this year's tax package:

   - Completed contract method for multiyear defense contracts.
   - Industrial development bonds (restrict, require matching efforts from State or locality, and sunset).
   - Eliminate insurance industry loophole (modified coinsurance).
   - Capitalization of construction period interest and taxes.

3. Underground Economy

a. The Compliance Gap

The IRS estimates that $100 billion is lost annually through noncompliance with the Federal income tax laws and that amount will rise to $133 billion by 1985. Our tax bill raises nearly 30 percent of its revenues, nearly $28 billion, by steps to help close this gap.

b. The Legislation

TEFRA improves the current system of information reporting. Nine to 16 percent of interest and dividends paid go unreported, as do 44 percent of capital gains. We can improve the reporting system by including Federal debt and bearer obligations and impose real penalties on those who refuse to comply.

c. Withholding on Interest and Dividends

The administration proposed withholding, and this has been adopted at a 10 percent rate. Exemptions are provided for the elderly and low income taxpayers, and protections are available to institutions while they make the transition to the new system. Withholding takes effect July 1, 1983, and brings in about $10.5 billion over 3 years without raising anyone's taxes.

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.

4. Minimum Tax

a. Prior Law

Prior law included three very complex minimum taxes, two on individuals and one on corporations. These taxes raised only $1.5 billion and still permitted significant numbers of taxpayers to pay no tax.

b. Tax Bill Provisions

The provisions in our tax equity bill completely revise and simplify the minimum tax. In lieu of the overlapping alternative and add-on taxes on preference items, the minimum tax on individuals is a flat rate of 20 percent for amounts over $30,000 on a more comprehensive, economic income base. Similarly, certain corporate preferences are cut back 15 percent.

c. The Tax Base: Individuals

Included in the tax base for individuals are adjusted gross income and items like excess accelerated deductions, intangible drilling costs, the "bargain" element of incentive stock options, research and experimental expenditures, deduction for long-term capital gains, interest on all-savers, and other items.

d. Corporations

Certain tax preferences for corporations will be cut back 15 percent. These include DISC, some percentage depletion, intangible drilling costs, interest deductions for banks to the extent that tax-exempt instruments are included in a bank's investment portfolio.

e. The minimum taxes are 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 20 percent, with a 15 percent scaleback for corporations: all taxpayers with substantial real income ought to pay some income tax.

5. Leasing

a. Over $8 billion is generated by cutting back on the safe-harbor leasing provisions of the 1981 Tax Act. Those provisions would otherwise cost about $30 billion over 6 years, and the figure could go higher when Treasury completely analyzes its report on leasing transactions.

b. Changes include a 1983 Sunset, offsets in other tax preferences, and direct limits on tax sheltering.

6. Altogether our tax package paves the way for a broader tax base, a fairer tax system. This is the direction we will have to take in future revenue bills.

B. Subchapter S and LIFO Reserve Recapture

1. The Subchapter S reform bill, H.R. 6055, was passed by Congress just before the recess. This is another simplification step in the simplification project being undertaken by the tax-writing committees.

2. The thrust of the Sub S bill is to reduce the significance of tax considerations in the choice of form of organization for small business. Taxing an electing Subchapter S corporation like a partnership allows taxpayers to choose a corporate or non-corporate form of organization based solely on business reasons.

3. To achieve this goal the rules governing subchapter S status are clarified and relaxed in some ways. Limitations on passive income are substantially reduced, and the number of shareholders permitted is raised to 35. The restriction to one class of stock for Sub S corporations is eliminated, and the taxation of Sub S income is conformed more closely to a partnership-like system. These and other changes in the bill simplify the decision whether to elect Sub S status, and are sound tax policy.

4. LIFO Reserve Recapture. H.R. 4717, which also was approved before the recess, resolves a significant issue for many businesses by providing a partial delay of the LIFO reserve recapture rule enacted under the Crude Oil Windfall Profit Tax Act. Under the conference agreement on H.R. 4717, the recapture rule would be deferred until January 1, 1983, but only for the first $1 million of LIFO reserves. In addition, to be eligible for this extension the actual liquidation must occur no later than December 31, 1983. (The original LIFO recapture rule provides that a corporation distributing LIFO inventory to its shareholders as part of a liquidation must recognize as ordinary income an amount equal to its entire LIFO reserve, and was due to take effect Jan. 1, 1982).

   H.R. 4717 as passed also provides a 10-year carryback and 5-year carryforward of net operating losses for Fannie Mae, among other provisions.

VII. Summary of Revenue Provisions. The Tax Equity bill raises $98.3 billion in new revenues over 3 years, as mandated by the budget resolution. This is not a fly-by-night revenue raiser: it is a carefully drawn, real tax reform bill. Most of the revenues are generated without touching the average taxpayer: in fact, no more than 25 percent of the provisions would be of concern to most taxpayers. This is an equitable tax bill, which emphasizes the following areas:

o Improved tax compliance. These are changes to insure that everyone pays a fair share of tax, before we add on new taxes. Improved information reporting is included, new penalties are imposed, and withholding requirements are strengthened, including withholding on interest and dividends at a flat 10 percent rate and a new allocation rule to help collect tip income.

Revenues raised: about $27.8 billion over 3 years.

o Reagan Proposals to Close Loopholes. This area encompasses the proposals to close loopholes and tighten up on overgenerous tax benefits that were proposed by President Reagan in his budget for FY 1983. The category includes restricting use of accounting loopholes by defense contractors, closing a major loophole used by the life insurance industry, IDB reform, and a minimum tax limitation on certain corporate tax preferences.

Revenues raised: about $24.7 billion over 3 years.

o Improvements in Tax Equity. In addition to the Reagan proposals, the bill focuses on other provisions that have proven to be overgenerous or that need simplification. These include pension tax reform, a stronger individual minimum tax, safe-harbor leasing, tax treatment of foreign oil and gas income, mergers and acquisitions, and reasonable limits on medical and casualty loss deductions to bring those provisions in line with economic reality.

Revenues raised: about $28 billion over 3 years.

o User Fees and Taxes on Those Responsible for Specific Spending. The bill includes higher airport and airway taxes as part of a widely supported package to bolster the Airport and Airway Trust Fund and finance airport and FAA improvements. In addition, Federal employees would be subject to Medicare tax to balance their contributions to Medicare with benefits. Similarly, the unemployment tax is raised to help finance the unemployment system without resorting to general revenues.

Revenues raised: about $11.7 billion over 3 years.

o Excise Taxes. The cigarette tax would be temporarily doubled and the telephone tax would be raised from 1 percent to 3 percent in 1983, 1984, and 1985, dropping to 0 thereafter.

Revenues raised: about $8.2 billion over 3 years.

* Note: Total adds to more than $98.3 billion because of some revenue-losing provisions, such as the jobs credit extension.

VIII. Flat Rate Tax

A. Growing frustration with our complex tax system and desire to insure fairness are increasing interest in a flat-rate, or low-rate, simplified tax. More people believe that the complexity of the tax law puts a premium on getting sophisticated legal accounting advice to take advantage of loopholes--and that seems to benefit the wealthy at the expense of the average taxpayer.

B. Several flat-tax proposals have been made, and there is no question that in the years ahead we will be working to simplify taxes, eliminate obsolete tax provisions, and bring rates down in exchange. At the same time, there is no comprehensive scheme we could implement right away--we need input from the Treasury, which is continuing to review the issue. Most proposals leave some progression in rates, allow for certain highly popular deductions, and exempt low incomes. When it comes to a comprehensive tax base, everyone has their favorite exemption they want to protect.

C. There will always be some complexity: we do have to define "income", and our work with the minimum tax may help us reach a more comprehensive definition. We also have to have a sensible relation between the taxation of individuals and the taxation of corporations. But we can agree on the principles of equity, balance, and simplicity in taxes, and work to improve the system. These are the issues the Finance Committee began to review on September 28.

IX. Balanced Budget Amendment

A. Our acute fiscal imbalance and signs of deterioration in the budget process are increasing support for constitutional restraints on fiscal policy. The Senate has approved S.J. Res. 58; 218 members of the House petitioned to discharge a similar resolution for floor action, but the House failed by 46 votes to get the necessary 2/3 vote.

B. S.J. Res. 58 would require Congress to adopt a balanced budget unless overridden by 3/5 vote, and an actual majority to raise taxes over the previous year as a percentage of national income. We would be obliged to balance and coordinate decisions on spending and taxation--a sort of "truth in government" provision.

C. No one wants to resort to the Constitution unnecessarily, but Congress has proved too often that it will not maintain long-term fiscal restraint. We need strong measures to redress that balance, and it may be that only the Constitution can provide them.

D. There is no "perfect amendment" and there are other ideas that merit consideration; a two-year budget cycle, an item veto for the President, and different accounting systems to clarify how we are spending taxpayers' dollars. But S.J. Res. 58 is as good a proposal as we have developed, and it deserves a chance to work. Enforcement legislation, and cooperation between the President and Congress, will be crucial to the success of this fiscal reform.

X. Social Security

A. Perhaps the most pressing and significant problem yet to be reckoned with is social security. 1981 was the seventh year in a row that the social security cash benefit programs (OASDI) spent more than they took in. Old-age and survivors insurance alone is losing about $30,000 a minute.

B. At this rate, the retirement and survivors insurance trust fund (the one that pays 75 percent of all benefits) will be unable to pay full benefits in July 1983, and the rest of the system will be in trouble within the following year.

C. Trust funds have never been so critically depleted. Prior to 1970, there were always reserves on hand capable of financing about 1 year or more of benefits--that is, reserves equal to 100 percent of annual outgo. By 1976, reserves had fallen to 57 percent of outgo and today, the combined reserves of the system stand at about 20 percent of annual outgo, or only 2 to 2 1/2 months worth of benefits.

D. The long-term problem is even more serious. Over the next 75 years, the actuaries estimate the deficit at $6.4 trillion, counting HI ($1.9 trillion excluding HI). This is the amount of money that would have to be put in the trust funds today, combined with interest and all future tax income, in order to be able to just pay off projected benefits as they become due.

E. When today's 20-year olds are retiring, say in the year 2025, the actuaries project the cost of benefits to be 25 percent of payroll (the combined employee-employer tax rate). About 40 percent of the cost of benefits in that year are unfinanced--left unprovided for. Under more pessimistic assumptions, the tax rate would be considerably higher than 25 percent.

F. These facts are underlying the growing lack of confidence among younger workers over the survival of the system. Some recent surveys show that as many as 75 percent of the people aged 18 to 29 have little or no confidence that social security can meet its commitments after the turn of the century. 64% lack confidence about the next few years.

G. The National Commission on Social Security Reform, which has now met 6 times, is charged with proposing a set of recommendations--with bipartisan support--for alleviating the short- and long-term financing crisis. We have a reporting deadline of December 31, but I am hopeful that a consensus will be reached to report immediately after the election, by say November 15. This would give Congress the time to meet in a special session or post-election session to move legislation through quickly.

H. It will be essential to consider ways of controlling costs, not simply raising revenues. Already, for one-quarter of America's taxpaying households, social security taxes are higher than income taxes. If, as economists argue, workers end up paying the employer's share of the tax in the form of lower wages, 51 percent of taxpaying households pay more to social security than to IRS. On top of this, there are 3 more tax increases in the law now (for 1985, 1986, and 1990).

I. With social security spending amounting to $3 trillion in the next 10 years, increasing by $20 billion a year, there is clearly room for belt-tightening without reducing current benefit levels. Eligibility can be tightened, the benefit formula can be increased less rapidly, the cost of living adjustment can be delayed or modified.

J. It's my hope that the Commission and Congress will face the issue squarely as soon as possible after the election, make the hard decisions that have to be made, and solve the financing problem once and for all.

XII. 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 had to establish our priorities swiftly but with care: not an easy task. But we have shown that we can work together to deal now with problems that have been building over many years; if we continue to do so, we will have a major breakthrough in favor of economic recovery.

B. Shared Effort. We are learning that 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 impedes further responsible action; what they care about are results.