REMARKS OF SENATOR DOLE

INSTITUTE FOR RESEARCH ON ECONOMICS OF TAXATION

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Reward for Mondale Plan

Our Economic Progress

- Our spectacular recovery remains on track and appears to be moderating to a pace that can be sustained in the years ahead. Real GNP grew 6.1% in 1983, and continued at a 10.1% rate in the first quarter of 1984, and 7.5% in the second quarter. This is the strongest recovery since 1961.

- With national unemployment down to 7.5%, this recovery has created 6.4 million jobs. Factories are operating at the highest capacity levels in 4 years, close to 82%. And the investment needed to sustain future growth is being made: businesses plan to increase spending on plant and equipment by 14.8% this year, the biggest increase in 18 years.

- The best news about this recovery is that inflation is staying low. Producer prices in 1983 showed that smallest increase since 1984. The 1983 CPI increase was just 3.8%, and consumer prices indicate we <u>can</u> sustain strong growth with low inflation. Consumer price increases are running at around 4%.

- Growth, lower inflation, and major tax relief have translated into <u>real</u> income gains for all Americans. Real personal income has risen by $116 billion since the low point of the recession (August 1982). For the first time since 1978, real income is growing.

- All the trends in the economy look good. Most observers believe the recent drop in the economic indicators just show a moderating pace of recovery. Meanwhile the prime rate--which rose from 6.5% to 21.5% under Carter-Mondale--stands at 13%. The misery index, which peaked at 24.3% in March of 1980, is around 11%. Auto sales and housing starts are up.

The Deficit Problem and Sustaining Recovery

- Just about everyone agrees that the deficit remains the number one obstacle to sustaining the strong recovery we have enjoyed to date. If we don't cut the deficit Federal debt will nearly double over the next five years to over $10,000 for every man, women, and child in America.

- By 1989 it would take half of all individual income tax payments just to pay the interest on the debt; the interest cost would be $250 billion, or about $1,100 for every American.

- Record deficits cannot be sustained, and they have very real costs. They drive up the cost of home mortgages, they threaten to rekindle inflation or crowd out private investment and lead to a new recession. And they hurt our businessman trying to compete overseas by keeping the dollar high, thus raising the price of goods we try to export.

- We have made a good start on the deficit problem with this year's Deficit Reduction Act. The President took the lead by calling for bipartisan negotiations on a down-payment deficit package. The so-called Rose Garden plan that emerged helped us pass the Deficit Reduction Act, which makes real spending cuts of $13 billion and raises about $50 billion in revenue, largely by reforms to close off tax shelters, plug loopholes, and defer some tax breaks scheduled to come on stream.

- The immediate goal now is to fulfill the entire Rose Garden plan--aimed at saving over $140 billion over three years--by keeping the appropriations bill in line with that budget blueprint. That will ensure that the primary emphasis in deficit reduction remains on spending restraint, where it belongs.

Mondale Deficit Plan

- The Mondale plan to cut the deficit just is not credible and not very specific on the spending side. Where President Reagan puts spending reduction and economic growth first in the deficit battle, Walter Mondale reaches right for the tax increase option as a first resort. By tampering with tax indexing, the Mondale plan would hit between 30% and 40% of taxpayers: those with income over $25,000. The Mondale surtaxes and rate changes for upper incomes are just more of the same kind of backward fiddling with the tax structure that has made our tax code so inefficient. By contrast, with his rate cuts and tax indexing, President Reagan set us on the path toward a lower-rate, broader-based and fairer tax system. Mondale would set tax policy back at least four years.

- On spending, the Mondale plan has very little that is real. $51 billion is saved from hoped-for interest savings, and while $54 billion in spending cuts are proposed, so are $30 billion in new spending. That means $24 billion in real spending cuts by 1989, mostly unspecified (like 'management initiatives'). Of the claimed $176 billion in deficit reduction in this plan, $153 billion comes from tax hikes, interest savings, and economic growth assumptions.

Major Tax Reform

- There is still a lot of interest in major reforms to make tha tax system simpler, fairer, and economically more efficient. The Treasury Department will report its options in December, and the Finance Committee is holding four days of hearings to hear from the public about possible alternatives.

- Everyone wants to improve the tax code, but it is important to build a consensus for any far-reaching changes, or else the new system begins to unravel again right away. So it may not be possible to jump into a new system in one step: we may have to proceed gradually, indentifying areas of agreement as we go along.

- We need to know how people really feel about the trade-offs they would face under a lower-rate, broader-base, or modified 'flat' tax. Would they really give up their favorite deductions and credits in return for lower rates? Or do they really care most about the bottom line--the size of their tax payment?

- We may be able to agree on some basic principles of tax reform, set a goal, and take initial steps toward that goal. That is why we are examining in some detail the more popular flat or 'quasi-flat' proposals, plus consumption taxes and the like. The important thing is to be sure that we are making an improvement: otherwise it is not worth the effort.

TALKING POINTS ON MAJOR TAX REFORMS

- We need to establish a framework to guide further deliberations on restructuring the tax system by clearly formulating the basic options, by developing the facts and figures necessary to informed decisions, and to pinpoint the technical and practical problems that will have to be dealt with if we want to modify the tax system in a major way. The Treasury Department at the request of the President is examining the issue in some detail, and we hope they will be prepared to make specific recommendations later this year.

- We have to decide whether significant progressivity in rates is desirable--as under the present system--or whether everyone should pay the same proportion of income in taxes. The answer to this question will depend in part on your view of how important the principle of progressivity is to maintaining popular support for the tax system. The answer also will depend on some simple facts: How progressive is the present system, when you take into account the distribution of tax preferences available under present law, particularly deductions that tend to favor those in higher rate brackets.

- We also have to determine how much a gain in simplicity and economic efficiency can be made by moving to a streamlined low-rate or flat-rate structure or to a system that taxes consumption. Defining income is always a source of major complexity, and cutting out tax preferences as such does not deal with that problem. A large zero bracket, if it were adopted as part of a restructuring of our tax system, could provide significant gains in simplicity by reducing the number of itemizers. Again, however, we would need to evaluate the impact of such a change on the distribution of the tax burden and in terms of economic efficiency. And consumption taxes demand the same sort of scrutiny.

- There are a number of specific ways in which a lower-rate or consumption-based tax system might be structured. A single rate could be applied, as some propose, to a comprehensive income base. This would mean everyone paying the same proportion of income in tax, with changes in the types of things we have usually included in income: Items such as social security and retirement benefits, among others. Alternatively, rates could be significantly reduced and the base broadened by eliminating a range of tax preferences, but without going all the way toward a single rate with a comprehensive base. These two basic options can be varied, in addition, by including in either a large zero bracket: Guaranteeing a degree of progressivity and protection for lower-income taxpayers, with some gain in simplicity as well from reducing the number of itemizers, assuming the option of retaining some deductions is chosen. We could also consider a flat-rate tax on a less comprehensive income base; preserving some basic tax preferences that have wide support, but at the same time presumably requiring a higher rate to generate the necessary amount of revenue.

- In the case of a tax based on consumption, the questions are whether to make it progressive, and how, whether to impose a tax on goods or their production, or just to exempt from tax everything that goes into saving; and whether to exempt certain necessities of life in either case.

- What it comes down to is a choice of ways to proceed. Everyone wants greater equity in the tax code, and a simpler system, and a tax system that promotes--or at least does not inhibit--economic activity. Choosing the system that best balances each of these goals is not easy, however: And deciding how to move toward a better system may be the most difficult choice of all. There is no point in making a change unless we make a big improvement. So far that case has not been proven for any of the major proposals on the table.

- We might agree to proceed, on a step-by-step basis, to couple base-broadening measures or steps toward a different tax base with rate reductions in an effort to simplify the system and reduce tax-induced distortions of economic decisionmaking. The advantages here would be that we would have an opportunity to think out each step as it is taken, and to build a consensus on the desirability of those steps. The disadvantage is that you would not make a specific commitment to a bottom-line goal for our tax policy.

- Just outlining the policy options and procedural options makes clear how much there is to be done if we want to rebuild our tax system in a way that is fairer, simpler, and better for the economy. No system can be sustained without a strong popular consensus: indeed, a major reason we are considering fundamental reforms is the indication of weakening consensus behind our present system, as demonstrated by the growing compliance problem. We do not want to hastily adopt a system that cannot be sustained over time, either because of technical flaws or lack of popular support.

- So our task is to begin to search out the kind of consensus needed to support any far-reaching change in tax policy. The direction has been set, in a way, by the rate reductions adopted in 1981 and the base-broadening and compliance measures we agreed to in 1982 and again this year. We have already moved toward lower rates and a broader base, and have put the pressure on to reexamine the tax system by indexing individual rates to end bracket creep. There does seem to be a growing consensus for further reduction of rates and broadening of the tax base. With proper balancing of the goals of equity, efficiency, and simplicity, that consensus could grow.