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United States Senate
OFFICE OF THE MAJORITY LEADER
WASHINGTON, DC 20510

November 8, 1985

TO: Senator Dole

FROM: George Pieler

SUBJECT: Talk to National Association of Realtors

Attached are materials for your talk to the Realtors convention in New Orleans, focusing on their support for deficit reduction efforts, including the balanced budget amendment, prospects for tax reform, and Senate agenda.

Senate agenda

• For the remainder of this year budget and deficit-control issues will continue to dominate the Senate schedule. We need to finish action on reconciliation and appropriations bills just to get the limited savings planned under our budget resolution for FY 1986. We hope to reach a time agreement on finishing reconciliation this week, and one way or another we have to deal with the continuing resolution on appropriations by November 14.

• The balanced budget amendment is still high on the agenda for this year, because the longer we drag on with frustrated attempts to deal with the deficit through the budget process or on the debt limit, the clearer it becomes that on overriding, constitutional, inescapable restraint on our spending habits is the only real solution. Even if Michigan has declined to petition Congress for such action, 32 other States have--and we have the responsiblity to act on our own initiative.

• Aside from these matters we have Superfund, conference agreements on appropriations bills, and possibly expiring provisions of the tax code to deal with: and we have agreed to an extensive debate of trade issues as part of the price of liberating the reconciliation bill for Senate action.

Attachments

Attacking the Deficit

o The deficit remains our number one economic problem: our number one domestic problem, because until we prove we're serious about the deficit, we will have no credibility on any other major issue, either.

o The National Association of Realtors has been a cornerstone of efforts in Congress, and on the part of President Reagan, to get the deficit under control. Your industry is at the heart of our economy: not just real estate per se, but construction, supplying materials for construction, and the pace of demand for new commercial and office space. Because real estate is so critically important to the health of the American economy, you have a keener understanding of the importance of responsible fiscal policy to our cities and towns and families: and to generations ahead.

o The Realtors have done yeoman service in the cause of deficit reduction--not just in supporting the Senate-White House budget, but in working for institutional reforms aimed at reducing deficits over the long term. Those reforms include the Gramm-Rudman-Hollings budget control measure and the balanced budget constitutional amendment.

o I urge you not to give up now, just because we haven't won all the battles we had hoped to win. Each of the initiatives you have worked for is becoming more and more urgent as time goes on. Unfortunately, the need to reform our fiscal policy may become apparent only when we approach a crisis point.

What is at Stake

o We have made tremendous strides towards putting the economy on a stable growth path without rekindling inflation. The deficit threat is the main threat to a sound economic future.

o The longer we postpone action on the deficit, the greater we increase the risk of either recession, or renewed inflation. The growing debt burden, already near two trillion dollars, simply cannot be financed without increasing costs--and growing risks--to both the American economy and the world economy.

o No one can be sure what the consequences will be if we fail to act on the deficit: and I, for one, don't want to find out. But some things are clear. One is that the deficit problem compounds itself. Each year that we add $200 billion in new Federal debt adds another $15 billion to the next year's interest costs. The exploding cost of servicing the Federal debt makes controlling spending that much more difficult each year. Already interest expense for FY 1986 is expected to reach $140 billion.

o In 1976 net interest accounted for just 7 percent of total outlays. But if we don't make progress on the deficit, by 1988 total Federal debt would equal more than half of total GNP, and net interest would rise to 14 percent of all spending. In short, the share of Federal spending we can control gets smaller every year.

o Higher and higher interest costs threaten to undo the progress we have made on spending reduction, and portend either massive tax increases or an economic tailspin later in the decade. The stakes are high: and the problem is acute.

Critical juncture

o This year--right now--there are other forces at work that put us at a critical juncture in the deficit-reduction battle. I am referring to the massive trade deficit, the Treasury's initiative to moderate the value of the dollar, and the uncertain pace of growth in the economy.

o We are making progress in bringing down the value of the dollar against the yen and European currencies, which in the months ahead ought to have a favorable impact on our trade posture by making American goods relatively cheaper to sell abroad. But we can't have any lasting effect--as our recent dollar agreement explicity acknowledges--unless we deal promptly with the economic fundamentals that lead us into this mess in the first place.

o In short, we have to reduce our budget deficit--cutting our need to rely on foreign capital to finance the American economy and the American government--if we are to halt the tide of protectionism without falling into the inflation-high interest rate trap.

o Already the market is looking for signs that the dollar agreement is reducing interest in investing in the U.S. If that interest does decline, while deficits to continue to mount, it doesn't take a genius to figure out that interest rates are likely to shoot up: unless we undertake a massive monetary stimulus that would spark inflation and ultimately lead to high rates anyway.

o So the time is now, if we really want to follow President Reagan's advice and eliminate economic barriers--trade barriers, interest rate barriers, tax and regulatory barriers--that hurt our economic performance. Unless we attack the budget problem immediately, and follow through on long-term reforms, we will see more and more new barriers erected: barriers that may not disappear in our lifetimes.

THE DEFICIT AND THE AVERAGE AMERICAN

- Unless we enact a massive deficit reduction measure, American families will face either higher interest rates or higher inflation: not to mention the risk of a disastrous new recession throwing millions of breadwinners out of work.

- Most economists believe that enactment of the deficit reduction package as large as the Senate offer will produce a drop of at least 1 percent in interest rates over the short run and 2 to 3 pecentage points over the long term: relative to what they otherwise would be.

- With a 2% drop in interest rates, the monthly payment on a median priced home ($80,000) will go down by about $100 a month.

- Conversely, if we don't reduce the deficit to keep rates as low as they are now, homeowners could face that large an increase-or-more in monthly payments.

- A 2% drop in interest rates would mean an additional $4,000 in income for the average wheat farmer with a 1,000 acre operation.

- This year alone, the Federal government will overspend close to $1,000 for every man, woman and child in America.

- This $1,000 per head of additional Federal debt will be one more burden for our children to repay in higher taxes or higher inflation in the future.

- I don't believe we can let this budget negotiation fail. If we don't act now on major deficit reduction, the American people will pay the price. By 1989, interest on the debt alone would take up half of all individual income tax payments. The interest cost would be $250 billion or $1,100 for each American.

- If we can get something like this package I am very, very optimistic about the course of the economy. I think we take too much for granted what we have achieved so far: strong growth without inflation. We can keep that going if we reduce the deficit substantially. The way is open to economic performance unprecedented in the postwar period if we have the will to find it.

Real estate issues in tax reform

• Generally, the income tax laws have given very generous treatment to real estate. Last year at the Finance Committee we examined the question of whether, if real estate were completely exempted from income tax, there would be a net gain or loss to the Treasury. While the exact estimates differ (depending on which tax preferences you deem to be "for real estate"), there seemed little doubt that, overall, real estate receives a net subsidy from the tax code.

• That is why President Reagan's tax reform plan, even though it doesn't touch many of the most important tax benefits for real estate, is bound to cause concern for the real estate industry. When we are trying to restore some balance to the tax code, and make it relatively neutral among different industries and types of investment, industries that are relatively favored under the current tax laws are bound to lose something.

• The President has time and again stated his determination that deduction for home mortgage interest will not be touched, and I can assure you that Congress stands foursquare with the President on this issue.

• At the same time, if we are serious about tax reform, some other sacred cows--depreciation schedules, the interest deduction for mortgages on second homes, the at risk exception for real estate, and syndicated real estate tax shelters--are going to be examined, and they are going to be touched.

MORTGAGE INTEREST DEDUCTION ON SECOND HOMES

- The President's tax reform plan would end the deductibility of mortgage interest on a second home, such as a vacation home. That change concerns the vacation home industry because they fear the loss of the interest deduction will cut the market for second homes, and reduce the value of existing second homes.

- One thing the vacation home industry could use reassurance on is the effective date for any change in the interest deduction for second homes. It is safe to say that any change will be prospective only, and that generous transition relief will be provided.

Taxing Large Limited Partnerships As Corporations

The proposal would treat limited partnerships with more than 35 limited partners as corporations. This would mean that the partnership could not pass through deductions to partners. The reason for the 35 partner rule is that Subchapter S corporations which are not subject to a corporate level tax may not have more than 35 shareholders.

Publicly-offered real estate syndications would probably end if this proposal were adopted because they depend so heavily on passing through interest paid and depreciation deductions to the partners. The major problem with the proposal is that it would cause a discrimination between larger investors who can keep under the 35 partner rule and smaller investors who cannot afford a big enough investment to invest in a syndication with no more than 35 partners. Obviously, it will also have a greater impact on large syndications, whether they are publicly offered or not.

The Finance Committee Subchapter C report had a less restrictive rule treating limited partnerships as corporations only if the partnership interests themselves were publicly traded like stock in a major corporation.

Elimination of the "At Risk" Exception for Real Estate.

Generally, the total amount of deductions which a taxpayer may take with respect to an investment is limited to the amount he has invested, including debt on which he is personally liable.

However, investors in real estate (and certain equipment leases) may also take deductions equal to their share of debt on which they are not personally liable ("nonrecourse" debt).

The Treasury proposal would make the at risk limitation apply to all investments, including real estate.

The at risk exception allows real estate investors a substantial benefit which is not available to other investors. It is difficult to justify and is a testament to the political power of the real estate industry in past years. As you may recall, the Moynihan minimum tax proposal in 1984 would have effectively repealed the at risk exception for minimum tax purposes. The Finance Committee decided to extend the ACRS recovery period for real estate instead.