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United States Senate

OFFICE OF THE MAJORITY LEADER
WASHINGTON, DC 20510

January 22, 1986

TO: Senator Dole

FROM: George Pieler

SUBJECT: Talk to National Realty Committee Chairman's Roundtable

Attached are materials for your talk to the Chairman's Roundtable of the National Realty Committee on Wednesday, January 22, at 8:00 at the Ritz-Carlton (deficit and tax reform).

In addition, as you know the group has some specific concerns on tax reform, as noted below. However, their concerns about the bill are less intense than last year, when Treasury II was proposed: many of their key issues were taken care of in the House. For example, depreciation for real estate came down to 30 years in the House bill, not too far from the 25 years advocated by NRC; the House rejected the 'windfall' recapture tax and limited the effect of extending at-risk rules to real estate; the House did not accept the proposal to deny capital gains treatment to depreciable real estate used in a business; and the House considerably watered down the proposed limits on interest deductions, and made only small reductions in the tax credits for rehabilitating structures (from 25% to 20% for historic structures).

In short, the real estate industry has already won some very major battles in the House. In the Senate, their attention will be focused on the following:

(1) In the House minimum tax, NRC objects to the effective date (1-1-86) and the $50,000 limit on the amount of passive loss in tax shelter activities that can be taken out of the minimum tax base.

(2) NRC continues to objec to <u>any</u> limitation on the deductibility of interest. Under the House bill, in general deductions for nonbusiness interest are limited to the amount of the taxpayer's net investment income plus $10,000. This does not affect interest deductions on a principal residence and also covers interest related to limited (passive) business interests.

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(3) NRC continues to believe that 30 years is too long a depreciation period for real estate, but feels there may be a better chance for restoring all or part of the administration's depreciation indexing proposal (rejected by the House) than in reducing the writeoff period for real estate.

Attachments

REMARKS OF SENATOR DOLE

NATIONAL REALTY COMMITTEE -- CHAIRMAN'S ROUNDTABLE

TUESDAY, JANUARY 22, 1986 -- 8:00 p.m.

Challenges for Congress in 1986

o In some respects 1985 was a year for setting goals and planning the policy agenda for the remainder of the 1980's. So the challenge of 1986 is to follow through: to make sure that the difficult goals the Congress has set for itself are met, and don't just become empty promises without substance to back them up.

o In domestic policy, our most pressing problems remain on the economic front: deficit reduction, tax reform, and a more realistic U.S. trade posture for an increasingly aggressive, competitive world economy.

o Specific legislation in each of these areas awaits Senate action in 1986. On the deficit, the first round of 'automatic' cuts under the new Gramm-Rudman law comes as early as March 1. On tax reform, the House-passed bill is ready for consideration by the Senate Finance Committee, which is expected to begin its work in February.

On trade, there are three major items that deserve the Senate's attention: the Danforth bill on trade with Japan, the telecommunications bill, and the 'omnibus' trade bill designed to strengthen the President's hand in bargaining with our trading partners and require decisive U.S. responses to unfair trade practices.

Other Major Legislation

In addition to these major economic issues, the Senate will take up the balanced budget constitutional amendment early in the new session. The first order of business before the Senate is the proposed sale of Conrail. We still have the Superfund toxic-waste cleanup legislation to deal with, even though the Senate did its best to get a bill to the President in 1985. We may want to take another shot at the line-item veto, the genocide convention, and school prayer, as well. And as always, events here and abroad can shape the Senate's agenda in ways no one can predict.

Gramm-Rudman: Challenge to the Established Fiscal Order

o The first actions in response to the new Gramm-Rudman deficit control reform will be taken early in 1986. For those of you who missed it, late last year the Congress imposed a new fiscal straightjacket on itself. The new law sets firm deficit targets for each of the new five years, and mandates automatic across the board spending cuts if the deficit exceeds the target. The first round of automatic cuts under the proposal will be announced on February 1, and those cuts will take effect March 1 unless Congress comes up with a better way to meet the target.

o In addition, President Reagan's budget for fiscal year 1987 is due to Congress by February 3. So we will have reconsideration of the 1986 budget proceeding simultaneously with our first shot at the 1987 budget.

That is a tall order, but is one we ought to be able to fill. Difficult as it seems, we should remember that the Gramm-Rudman law contains new procedures designed to make it easier to meet the deficit targets. We explicitly bring loan programs and other 'off-budget' items into the budget process; set a point of order against legislation from committees that have not met their budget savings allocation; and rule out of order legislation inconsistent with the deficit targets.

Possible Problems. We know there may be a rocky road ahead in implementing Gramm-Rudman. Congressmen Synar and others have filed suit claiming it is unconstitutional, and the Reagan Administration has some problems as well with the role of the Congress' General Accounting Office in mediating the deficit forecasts. The courts will have to guide us on all that. Even more important, what Congress can legislate, Congress can back out of. That's why we need a constitutional mandate for budgetary restraint, as well as a statutory one.

o So Gramm-Rudman hasn't made our options any easier: but if it works as planned, it will force us--and the President--to make some decisions and choose among the various deficit-reduction options. That means everyone's cherished spending programs will be put to the test of fiscal responsibility.

Spending the Key. Finally, let me emphasize that Gramm-Rudman is a device for reducing Federal spending. It is not a tax increase plan, or a subterfuge for one. If we fail on the spending front, we can look at other options. But the sooner we entertain any revenue options, you can bet the pressure for spending cuts will drop fast.

The Deficit and the Average American

- o Unless we follow a deficit reduction path like that mandated under Gramm-Rudman, 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. That is what the Gramm-Rudman-Hollings initiative is all about.

- o Most economists believe that enactment of deficit reduction measures that eliminate the deficit by the end of the decade will produce a drop of at least 1 percent in interest rates over the short run and 2 to 3 percentage 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) would 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.

  -- In 1985, 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.

Interest on the Debt

The massive increase in debt has itself created one of the largest and fastest growing components of Federal spending--interest on the debt. Constant deficits have put fiscal policy on an endless treadmill of paying for the irresponsibility of previous decades:

- o In 1965, interest on the national debt cost $9 billion and consumed 1.4% of GNP. By 1980, annual interest costs rose to $52 billion--2% of GNP. But the worst was yet to come.

- o In 1985, interest on the national debt cost taxpayers $130 billion--almost three times the level of five years ago. this represents 3.8% of GNP, 13.5% of the entire 1985 budget, and a 1,450% increase in costs over 1965.

- o $130 billion is equal to the sum total of all Federal spending from 1789--the founding of the republic--to 1936. It also equals total Federal outlays in 1966, the entire defense budget in 1980, and twice the level of medicare funding today.

But <u>if</u> we can adhere to the deficit-reduction goals we've set for ourselves, 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 <u>without</u> 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.

HOUSE TAX REFORM BILL

Anti-business ?

- The House bill raises corporate taxes by $141 billion over 5 years.
- The President's proposal raises corporate taxes by $131 billion over 5 years.
- The House bill sets a 36% maximum corporate rate.
- President's proposal sets a 33% maximum corporate rate.
- Both proposals repeal the investment tax credit.
- The House bill reduces depreciation deductions more than the President's proposal which stretches the deductions over a longer period, but provides the same present value for the deductions because of the full indexing feature.
- The House bill provides a 20% research and development credit.
- The President provides a 25% credit.

Anti-family?

- Both bills substantially lower real income tax liability, not just rates, for individuals in every income category. Both give the biggest percentage reduction to lower income individuals.
- The House bill raises the personal exemption from $1,080 to $2,000 for nonitemizers and to $1,500 for itemizers.
- The President's proposal raises the personal exemption to $2,000 for everyone.
- The House bill benefits families who itemize by retaining the state and local tax deduction and more interest paid deductions (interest on mortgage on second home plus $20,000 cap on other interest for married couples).

- The President would limit interest paid deductions to interest on a mortgage on a principal residence plus $5,000.

- However, families will reach the 35% bracket $22,000 sooner under the House bill than under the President's proposal, adjusting for computational differences.

Anti-savings?

- The House bill reduces the maximum annual deferral of compensation under a 401(k) plan from $30,000 to $7,000. A 401(k) plan is a profit sharing plan which allows employees to elect to defer part of their compensation.

- The President's plan would repeal the 401(k) plan provision entirely.

- The House bill does not provide any spousal IRA and, in fact, reduces IRA's for employees who participate in a 401(k) plan.

- The President would provide for an additional $2,000 maximum deduction for contributions to an IRA on behalf of a spouse who works in the home.

- The House bill reduces the amount of annual deductible contributions to company pension and profit-sharing plans. But, importantly, it reinstates indexing of these limits. It is difficult to say that funding for a $77,000 annual retirement benefit is not a sufficient tax-advantaged start to a good retirement. People still can save more on an after-tax basis.

- The President has not proposed reducing the annual contribution limits.

- The House bill raises the effective maximum individual tax rate on long-term capital gains from 20% to 22%.

- The President's proposal lowers the long-term capital gains rate for individuals to 17.5%.

Effective Date Resolutions

- On December 17, the House agreed to a Sense of the House resolution offered by Congressman Michel instructing the chairman and ranking member of the Ways and Means to work with the chairman and ranking member of the Finance Committee and the Secretary of Treasury to prepare and make public by the end of this year a list of tax reform items which should not become effective until January 1987.

- To date, the principals have not sat down to discuss possible items which should have a prospective effective date. Their staffs have not yet been instructed to get together for any preliminary discussions either.

  Senator Packwood is evidently concerned about possible "run on the bank" if a joint statement were released indicating that certain changes will not be effective until some future date.

- On December 19, the Senate also agreed to a resolution on effective dates. The resolution which I offered for myself and 55 of my colleagues says that our goal generally should be an effective date of January 1, 1987. If we have to differ from that date to protect taxpayers or the Treasury from unintended affects caused by major changes in tax policy, then we will do it. But, in general, people should be able to go on about their business relying on present law while we deliberate its future.

Tax Reform Talking Points

- The President's tax plan and the House bill are similar in concept--they both shift more of the tax burden to corporations and reduce the tax burden on individuals. But the bills are very different in how they make the change.

- Both substantially reduce tax rates for individuals (the President to a maximum of 35%; Ways and Means to 38%) and for corporations (President 33%; Ways and Means 36%). But the Ways and Means rates take effect at much lower income levels: the 35% rate clicks in at $43,000 for married couples, as opposed to $70,000 under the Reagan plan.

- Neither plan gets an A+ for the major objectives of tax reform--simplification and fairness, but the President's plan repealed many more of the overly complicated provisions of the tax code than the Ways and Means Committee effort. The House bill just modifies, but leaves in place, many complex tax rules.

- The House bill falls far short of the President's on fairness grounds. Fringe benefits and itemized deductions are major causes of differing tax liabilities, and unlike the President's proposal, the House retained the State and local tax deduction, did less to limit interest-paid deductions, and did nothing on fringe benefits. This means that taxpayers with equal incomes can still have substantially different tax liabilities.

- The House retained many of the politically popular big-ticket items like tax-free fringe benefits and the State and local tax deduction. Unless we want to tackle those, the Senate will have limited flexibility in trying to enhance investment and savings incentives.

- I have personally long favored income tax reform and, as Chairman of the Senate Finance Committee, led the fight over a number of years to plug unjustified tax loopholes.

- Nevertheless, I know that many of my Senate colleagues have no enthusiasm for the President's version of tax reform and even less for the House bill, which they view as even more likely to have harmful economic effects. In the Senate, with its more open procedures, it is easier for a determined minority to block or slow down a bill they oppose.

- It is possible that the Senate might be able to fashion its version of a tax reform bill by June, but only with intensive effort by the President to push the bill and reshape it along the lines he favors.