February 25, 1986

TO: SENATOR DOLE

FROM: GEORGE PIELER

SUBJECT: TALK TO PROFESSIONAL INSURANCE AGENTS

Attached, for your talk to the Professional Insurance Agents breakfast at 8:30 a.m. on February 26, are materials on the economy and the budget, updated tax reform talking points, and talking points Rich prepared on their particular tax concerns. Also, background material on their concern with insurance activities by bank holding company subsidiaries.

THE ECONOMY IN 1986

- No one can really predict the course of the economy in 1986, although of course we have to take a stab at it to guide our budget decisions. But it is increasingly clear that the economy began picking up late last year. Leading indicators rose 0.9% in December, the eighth month in a row. Unemployment is down to 6.7%, the lowest since 1979.

- There are forces at work that improve the prospects for strong growth this year. One of these is the drop in oil prices, which acts like a tax cut for energy users and helps moderate inflationary pressures that might build as a result of the dollar's decline. Coupled with the monetary stimulus the Federal Reserve provided in the last six months of 1986, and the prospect for improvement in our balance of trade later in the year (as the effects of the dollar decline are felt), this means we have a good chance for healthy growth in 1986.

- Clearly the number one threat to maintaining a healthy economy remains the U.S. budget deficit. If it's not reduced sharply this year, we won't meet the commitment we made to our trading partners to secure their agreement to ease the dollar down. What's more, we would put an unconscionable burden on the Federal Reserve to keep the recovery going by pumping more money out in order to keep interest rates down. That's a sure recipe for inflation.

- We've created 9 million jobs with a near record economic recovery. We've got inflation down to the lowest levels in two decades. Let's not throw it all a way by punting on the deficit issue. The fact is that <u>all</u> the economic pundits we've been hearing in recent years have been wrong: the economy is more resilient than many believed, but not so strong as to be able to sustain huge deficits this late in the recovery. It's time for everyone to "give" a little in the interest of a deficit-reduction plan that will steer us safely through the potentially treacherous waters ahead.

February 19, 1986

BUDGET FOR FY 1987

- The President's budget for FY 1987 is a blueprint for deficit reduction that Congress will have to take seriously even if we can't agree with it in all particulars. It is important to keep in mind OMB Director Miller's contention that, if we adopt this budget in full, we can meet the Gramm-Rudman targets for the rest of the decade without the need for major additional cuts.

- The 1987 budget plan is designed to get the deficit down to $143.6 billion: just below the G-R-H target of $144 billion. Total spending is projected at $994 billion, and revenues at $850.4 billion. Total interest expense is $206.85 billion, and net interest (exclusive of intra-government payments) is $148 billion.

- The deficit would be reduced by $38 billion in FY 87, and by $166 billion over three years. Defense would still grow by 3% in real terms (increase in budget authority adjusted for inflation). Increased funds would be provided for fighting terrorism, for law and drug enforcement, for the space program, aviation safety, and AIDS research.

- Major new deficit-reduction initiatives include privatization of government activities, ranging from Amtrak to power facilities to Ex-Im bank loans; transferring a few programs to the States, such as the Agriculture Cooperative Extension Service and highway; a wide array of user fees on government services; eliminating programs like EDA, UDAG, SBA, maritime subsidies, and the ICC.

- There are additional receipts in the budget as well: extending the cigarette tax, higher fees for black lung, repealing the gasohol exemption, increased contributions to civil service retirement and the like.

- The CBO indicates that the President's budget may be some $14 billion short of its 1987 goal because of low estimates of defense spending already in the pipeline. That is a legitimate matter for review, but if baseline spending is higher, then any cuts will have more of an impact as well.

February 25, 1986

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.

- 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.

- The Senate Finance Committee now is expected to begin action on tax reform in the second or third week of March. A lot of difficult decisions await the Committee if it is to make significant progress towards the goals the President has outlined: lower tax rates, a $2,000 personal exemption for everyone, and more incentive for saving and capital investment.

- I strongly believe that whatever we do on tax reform should be confined to trade-off between broadening the income tax base and lowering income tax rates for business and individuals. We should not resort to the gimmick of new taxes or add on taxes just to avoid tough decision on tax reform.

- Above all, we should not lose sight of the basic goals of tax reform: lower rates and a more equitable, level playing field that will be more productive for the economy and fairer to the average taxpayer. This is the latest step in the direction we set when we indexed the tax code in 1981 and began major tax reforms in 1982.

February 24, 1986

STATE AND LOCAL TAX DEDUCTION

- o I know a number of you are concerned about the possible loss of the state and local tax deduction. And you probably are also concerned that I have been reported as saying we should not take the state and local deduction "off the table" as the Senate considers tax reform.

- o I want to assure you that I have no interest in singling out this deduction. Nor do I have a "hidden agenda" to reduce government activity at the state and local level.

- o However I am a realist. If we are going to accommodate the President and reduce tax rates, we must find revenue sources which will make rate reduction possible. We cannot do it solely by raising corporate taxes. The President originally proposed raising corporate taxes by $131 billion over 5 years, but he still needed to repeal the state and local tax deduction to reach his goals for individual rate reduction.

- o In contrast, the House did not repeal or modify the deduction, but they had to add a 38 percent bracket and they had to compress the tax rate brackets substantially so that individuals would reach higher brackets sooner. In addition, they had to put interest in tax exempt bonds in the minimum tax. They also would raise corporate taxes by $141 billion over five years. These changes certainly are not without controversy either.

- o If we are going to try to act on the President's request to improve on the rate structure designed by the House, we will have to address the items that reduce taxable income for individuals. That list is short--itemized deductions and fringe benefits. The only significant itemized deductions from a revenue standpoint are interest paid, charitable contributions and state and local taxes. Similarly, the only significant fringe benefits are group health insurance and group term life insurance.

- o I don't think that home mortgage interest is a likely revenue source given the President's and House's position against any change. And I doubt that there would be much support for limitation on the charitable deduction. (The opposition even to putting appreciation on donated property in the minimum tax base should give us some sense of that.) However, I would not be opposed to reviewing the deduction for consumer interest paid, as well as the deduction for state and local taxes.

- I also would not be against finding some limitation on the exclusion for fringe benefits. However, the opposition to any change in the fringe benefit areas will also be very strong.

- All in all, our options will be limited if we are going to reduce tax rates. I don't know precisely what will happen on tax reform, but, if we are going to be serious about it, we will have to be prepared to compromise on some difficult issues.

February 25, 1986

TAX REFORM

The National Association of Professional Insurance Agents is a nonprofit trade association representing independent agents who sell property and casualty insurance. Their primary tax reform concerns are 401(k) plans, tax exemption for employer-provided health benefits, and taxation of property/casualty insurance companies.

401(k) Plans

- I understand that, as a nonprofit association, you oppose the prohibition of tax-exempt organizations including governments from offering 401(k) plans. Although the House bill has a grandfather rule for some plans, I can understand your view that basing the grandfather on whether the organization had filed for a determination letter by a certain date is unfair.

- Very little of the revenue associated with this proposal evidently relates to nonprofit organizations rather than governmental units.

- I also can understand your concern about the so-called "first dollar offset" against IRAs. It seems to be questionable policy to deny IRAs to anyone who defers $2,000 under a 401(k) plan. If the perceived problem is that wealthier taxpayers have too much incentive under these arrangements, a last dollar offset would make more sense. My guess is that the Ways and Means Committee adopted the first dollar offset more for revenue, rather than for policy reasons.

- I know you are also concerned about lowering the maximum amount that may be deferred under a 401(k) plan from $30,000 to $7,000.

- While that may seem to be a large reduction, it is still three and one-half times the maximum that can be contributed to an IRA and certainly better than complete repeal of 401(k) as proposed by the Administration.

- I am not sure what the Finance Committee will do in this area, but I would not be surprised if some limitation were approved. There will be a need to raise some revenue to reduce rates and the House provision was estimated to raise $4.9 billion over 5 years.

BANK INSURANCE ACTIVITIES

- o The Professional Insurance Agents are not keen on having bank holding company subsidiaries underwrite or market insurance. The 1982 banking bill generally restricted bank holding companies from engaging in those activities, but many bank holding companies (BHC's) continue those operations by acquiring State-chartered bank subs that are authorized under State law to engage in insurance activities.

- o In FY 1984 the Senate passed a bank bill (which died) that would have extended the insurance activity prohibition to bank subsidiaries of BKC's, pursuant to an amendment offered by Senator Dodd.

- o PIA believes the 1982 law should be construed to prohibit insurance activities by State-chartered bank subsidiaries of BHC's. The industry is looking for an opportunity to revive the 1984 provision when Congress moves to close the nonbank-bank loophole. In 1984 you supported the prohibition amendment offered by Senator Dodd.

- One thing that you might want to keep in mind is that the primary feature that makes 401(k) plans vulnerable is that, unlike other defined contribution plans, amounts can be withdrawn in the case of hardship. The generous way the IRS has defined "hardship" to mean events such as college education and other foreseeable events makes it difficult to view these plans as retirement plans.

- I understand that increased saving is important, but the same flexibility that makes these plans attractive also causes concern on the part of some that these plans may get out of hand.

Limitation of Exclusion for Employer-Provided Health Benefits

Generally

- As you know, outside the retirement incentives, the most significant statutory fringe benefits from a revenue standpoint is employer-provided health care. The Joint Tax Committee staff estimates that the exclusion for employer-provided medical care will reduce revenues by nearly $24 billion in 1986.

- Obviously, those individuals who benefit from having this compensation excluded from income tax oppose any change in current law. On the other hand, it is also clear that these individuals receive a benefit that other individuals who pay for their own health care with after-tax dollars do not receive and, as a result, tax rates have to be higher for everyone.

President's Proposal

- The President's plan would impose a $25 per month floor on the exclusion for employer-provided medical care for family coverage and $10 per month employee-only coverage, instead of the cap included in the original Treasury proposal. This was a disappointing decision. The floor would raise less revenue than the cap as originally proposed. But that is not an excuse to prefer a floor. The cap could be raised sufficiently to have the same revenue impact as the floor.

- The major problem with the floor proposal is that it is difficult to defend from a policy viewpoint. Its only virtue is that it taxes a small part of previously untaxed compensation and allows a little more rate reduction. However, if only a portion of this income should be taxed, a cap is preferable from both a health policy and general social policy perspective.

- As a practical matter, Senator Packwood and a number of other members of the Finance Committee oppose any change in this area and it would be unlikely, although not impossible, that either a cap or floor will be adopted.

Property/Casualty Insurance Companies

- The President's proposals included a type of discounting for loss reserves to reflect that some claims will not be paid for several years.

- The House bill did not adopt the discounting concept, but it did adopt various proposals which are designed to raise property/casualty company taxes by $4.8 billion over 5 years. It also includes an alternative minimum buy with a deferred effective date. I understand that this proposal concerns many companies.

- I have been informed that the members of the major insurance trade associations have agreed, at least in concept, to a package which includes a simplified reserve discounting proposal and is intended to raise the same $4.8 billion over five years. I also understand that, as under the House bill, some smaller companies may even get a tax cut under this proposal.

- I am sure the Senate will consider very carefully this proposal after more details are presented to us.

- In analyzing any proposal, it is important to keep in mind that no one wants to impose an income tax liability on companies who are, in fact, not making any profit in an economic sense. If companies are in a real loss position, they should not be taxed and Congress will not impose an income tax to meet an arbitrary revenue goal. On the other hand, if "losses" are only due to special tax breaks and a company really has profits, there is a good argument based on equity that a lower rate tax should apply to those profits. That is the concept behind the President's tax reform package generally.

Gramm-Rudman, the Dollar, and Inflation

- Gramm-Rudman should help us meet the commitment we made last September to our trading partners: to reduce the deficit as part of our effort to moderate the value of other dollar.

- By the same token, the risk of inflation should be reduced if we bring down the deficit under Gramm-Rudman, because the pressure to pump up the money supply to keep interest rates down will ease considerably.

Gramm-Rudman: Challenge to the Established Fiscal Order

- 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 take effect March 1 unless Congress comes up with a better way to meet the target.

- In addition, President Reagan's budget for fiscal year 1987 is due to Congress by February 5. 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 will be a rocky road ahead in implementing Gramm-Rudman. Congressmen Synar and others already have won the first round in their suit claiming it is unconstitutional, and the Reagan Administration also has some problems with the role of the Congress' General Accounting Office in mediating the deficit forecasts. The Supreme Court will have to give us a final ruling on all that in a few months. 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.

- 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

- 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.

- 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:

- 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.

- 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.

- $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 if 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 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.