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

June 22, 1983

TO: Senator Dole

FROM: George Pieler

SUBJECT: Remarks to National Realty Committee

Attached is an updated Outline of Remarks for your talk today to the National Realty Committee (update includes economic statistics and status of budget process).

Also attached is a copy of Andre's June 20 talking points on public property leasing, an issue the group indicated might be raised in questions.

The Realty Committee, of course, is also interested in any possible tax changes that might affect their industry in connection with a revenue-raising mandate to the Finance Committee: including modifications of ACRS for structures (now given a 15 year writeoff period) and changes in section 189 (construction period interest and taxes: last year in TEFRA we required corporations to capitalize, rather than deduct in the year paid or accrued, construction period interest and taxes for nonresidential real property).

Attachments

June 20, 1983

Public Property Leasing

Background

- On May 24, 1983, Congressman Pickle introduced H.R. 3110. The purpose of the bill is to eliminate the tax benefits of public property leasing. On that same date, I announced that I would introduce similar legislation in the Senate. The Senate bill should be introduced later this week.

The Problem

- Under current law, the Federal Government, State and local governments, and other tax-exempt entities have strong tax incentives to engage in leasing transactions.

- The use of long-term leasing by governmental entities can subvert the Federal, State and local budget process. At the Federal level, for instance, the use of leasing by the Defense Department can allow the Executive Branch to maintain spending levels in excess of those permitted by the budget by transferring a portion of the cost of military equipment to the Treasury Department as a reduction in receipts.

- At the State and local level, use of long-term leasing may permit governmental entities to avoid the requirement of voter approval often applicable to conventional bond financing.

- Lease financing by tax-exempts also allows such tax-exempts to trade on their tax exemption and to sell the benefits of accelerated depreciation, and in some instances, the investment tax credits.

- Because of the clear tax incentives to engage in leasing, if the Federal tax laws are not amended to remove the current benefits, much existing and new property would be leased.

Types of Leases

- Bennington College, as well as other tax-exempt educational institutions, have planned long-term leases of the college buildings. If many New England colleges engaged in such transactions, they could even obtain the 25 percent historic rehabilitation tax credit.

- The Navy has contracted to lease certain supply ships for the rapid deployment force. Under those contracts, the Navy even agrees to indemnify the private investors against the very real risk that the IRS will deny the investment tax credit on such deals.

- Foreign airlines which are tax-exempt have also benefited from this apparent loophole. Air France, for example, can lease

Airbusses from Citibank for 18 years for service between Paris and other European cities. Although the investment tax credit will not be allowed, accelerated depreciaton will be available (but not ACRS). If the planes fly between Miami and the French West Indies, however, both the investment tax credit and ACRS benefits will be available. It was never the purpose of ACRS to encourage Citibank to own an 18-year old airplane in the year 2000.

o The Treasury Department has estimated the potential revenue loss from allowing this loophole to remain at billions of dollars annually.

Differences of the Senate Bill

o I expect that there will be several important differences from the Pickle bill in the Senate bill.

o The House bill is unintentionally harsh in its treatment of short-term computer leases by tax-exempt entities. Under that bill, cost recovery of such computers would be over 12 years straight line, rather than over 5 years on an accelerated basis. The Senate bill will provide substantially more generous treatment for such property, and may entirely exempt certain leases.

o The House bill provides a special rule for the rehabilitation tax credit. I am studying whether a special rule for such credits is appropriate. If other tax credits are denied, why should a special rule permit rehabilitation tax credits to be available to tax-exempt users?

o The House bill, despite its good intentions, fails to eliminate the tax benefits of deals like the Bennington College lease. To prevent such tax motivated deals a significantly longer lease term would be necessary.

Effective Date

o We expect to keep the House effective date generally applying the new rule to property placed in service after May 23, 1983, with an exception for property under contract on that date.

OUTLINE OF REMARKS

NATIONAL REALTY COMMITTEE

June 22, 1983--11:00 a.m.--Hyatt Regency

I. The President and the Congress

A. President Reagan knows that he and the 98th Congress need to deal with a number of pressing problems, but at the same time he is putting firm limits on possible areas of compromise. We have had constructive action on social security. But the deficit urgently needs to be dealt with. As we proceed we should not compromise away the gains won towards restraining the growth of spending, controlling the tax burden, and beating back inflation. The American people still overwhelmingly support those goals.

B. The President still sets the agenda. On taxes, spending, deficits, employment, and trade the President proposes, and Congress must dispose. Those of us who have ideas of our own will work with the White House to get things done--but leadership still must come from the President. That is why we are unlikely to see any major departure from the principles of government Ronald Reagan has espoused in his first two years in office.

C. The fact remains that there is no coherent alternative to Republican leadership. The people still recognize that our economic problems were a long time in the making, and that the cure will take time too. According to CBS/New York Times voter exit polls in the last election, voters by a 5 to 4 margin blamed our economic problems on past Democratic policies rather than on President Reagan.

II. The Economy

A. Prognosis. We have to realistically assess the state of the economy and the prospects for the next few years. Recovery is well under way, and the groundwork has been laid for a stable and lasting growth well under way without renewed inflation. It is absolutely crucial that we proceed with care at this point, and not throw away the gains already made.

No one should doubt that we are making progress. The "flash" GNP indicator for the second quarter of 1983 shows growth at a 6.6 percent rate. The index of leading economic indicators has jumped 10 months in a row. Industrial output rose 2.1 percent in April; the highest monthly rise in 8 years, and 1.1 percent in May. Economists agree we are in a broad based recovery.

1. Inflation was cut to 3.9 percent in 1982, from 12.4 percent in 1980. This is the lowest inflation rate since 1972. And the trend is continuing: consumer prices rose less in the first quarter of 1983 than in any quarter since 1965. The 0.6

percent rise in the April CPI was largely due to the gas tax increase and bad weather boosting food prices.

2. Interest rates are down and still falling. The prime rate is down to 10 1/2 percent, way down from the 21 percent that prevailed when President Reagan took office. Home mortgage rates are down since last year. Long-term rates for business loans are off about 3 points from a year ago.

3. Lower taxes with major improvements in tax equity will help buoy the recovery, both on the consumer side and on the investment side. The combined effect of the 1981 and 1982 tax bills has been to lower individual taxes over 3 years by $344 billion, as well as improve compliance and tax fairness. Lower individual rates boost personal income and restore incentive, while favorable capital cost recovery rules should spur investment.

4. Housing starts are up at a 1.8 million annual rate, the highest in 3 years; the stock market is up 460 points over last August. These are tangible evidence of recovery. Consumer confidence is rising; retail sales rose 1.6 percent in March, 1.7 percent in April, and 2.1 percent in May, and auto sales were up 5.2 percent in the first 10 days in May. Inventories have been cut to their lowest levels in 2 years, and have begun to rise again.

B. Unemployment. The January drop in unemployment to 10.4 percent was followed by further declines down to 10.1 percent in May. Unemployment, of course, remains the major negative in the economic picture. High unemployment has to come down and stay down without inflationary stimulus--that is what we have failed to do in the past. Total employment is up 1/2 million since December.

o Clearly there is a bipartisan consensus for more jobs. But resuming the inflationary policies of the past will not create lasting jobs, just an illusion of prosperity that leaves us worse off the next time we try to get "off the wagon."

o That means the most important thing we must do is judge carefully the degree of stimulus the economy can and should take, consistent with a firm anti-inflation policy. The Federal Reserve will play a key role, and has already shown a willingness to adjust its short-term goals based on its assessment of the economy. We will not allow the recession to continue, but we will not reinflate the economy, either.

In addition, constructive steps have been taken:

- A new Federal supplemental unemployment compensation program was passed with the 1982 tax bill, providing unemployment benefits to well over 2 million workers. This program will extend through September 30.

- The new Job Training Partnership Act emphasizes training for permanent employment rather than make-work jobs.

- The targeted jobs tax credit, which was extended for 2 years by the 1982 tax bill, gives employers an incentive to hire the disadvantaged--about 600,000 workers are certified under the program.

- The administration's enterprise zone legislation, just approved by the Senate, can provide us with an experiment in private-sector job creation in depressed areas, through a combination of Federal tax incentives and State and local efforts to target an area for development with regulatory and tax relief, neighborhood participation, and capital and other improvements.

C. The Deficit and Interest Rates.

1. All our economic difficulties are, of course, related--high interest rates and slow growth boost the deficit, and higher deficits create greater uncertainty in the business community as to our future course; will there be more inflation, or less credit available for business expansion?

2. Because of this, it makes sense first of all to chart a path that is most likely to bring stable growth without inflation. Higher growth boosts revenues and cuts unemployment costs, thereby reducing the deficit as well: already, upward revisions of growth estimates are being made in light of our economic progress and indications of further improvements.

3. Continued efforts to restrain the deficit by controlling Federal spending will give the Federal Reserve a bit more room to accommodate the potential for real growth that exists in the economy without inflationary pump-priming. But restraint in both fiscal and monetary policy is crucial if we want to maintain long-term confidence in the economic program. The reappointment of Chairman Volcker at the Federal Reserve is a good move towards maintaining public confidence.

III. The Budget

A. Conference Agreement. The conferees on the budget resolution have tried hard to reach a reasonable agreement, but the result demands careful study before we concede that this is the best way to reduce the deficit. Of the proposed deficit-reduction measures, 88 percent is within the jurisdiction of the Finance Committee--and 86 percent is due to proposed tax increases, not to spending restraint. The conferees propose a

$73 billion tax increase over three years, $12 billion in 1984, $15 billion in 1985, and $46 billion in 1986.

B. Real Choices. Because so much in the way of spending programs is left out-of-bounds, the real choice proposed for us is to raise taxes or accept for now the high deficits that result from our spending decisions. That is not an agreeable choice to make, particularly when the conferees are proposing a so-called "contingency fund" to allow for new spending if Congress decides it is needed--to the tune of over $8 billion.

C. Implementation. One relevant question in evaluating the budget agreement is whether the votes exist to implement it. Many members who supported the House or Senate budget resolutions might not be as willing to vote for the tax increases needed to implement the conference agreement. If so, it would not help financial markets to propose a resolution that would not be acted on in any event.

D. Domestic spending. While we cannot let the burden of deficit reduction fall on benefits for lower-income Americans, we should not assume that domestic spending is untouchable. Even the budget conferees agree that, for example, Medicare is a proper source for savings. Certainly we have to acknowledge that Federal health program costs are out ot control, and that changes are very much in order. (The conferees propose about $1.7 billion in Medicare savings).

E. Even if we fail to pass the conference agreement, or fail to implement it, that does not mean the fight against the deficit is over. The President will use his veto to try to keep spending in line, and he has a lot of supporters who will help him sustain those vetoes. In many areas hand-to-hand combat over specific programs may achieve more real results.

IV. Taxes: Third Year and Indexing

A. The President has said time and time again that he will fight to retain the third year of his tax cut and indexing, and many of us will continue to support him, even if a veto is required. Thirty-four Senate Republicans and 146 House Republicans have signed letters to that effect. The reasons are quite simple: these measures are good for the economy, they are fair, and they give long-needed real tax relief to the hard-pressed middle income American.

B. Third year. Why is the third year important? First, most economists agree that the timing of this last stage of President Reagan's individual tax program is excellent in terms of giving the economy a boost on the consumption side as we emerge from recession. This is a sharp contrast with the past, when tax changes to counter recession were too little and too late.

Equally important, the third year is needed in the interest of fairness. Only the third year gives a full measure of tax relief to working people. For taxpayers with incomes $10,000 or less, repeal of the third year means a tax increase averaging 13.9 percent. For those between $20,000 and $30,000 in income it means a 12 percent jump in taxes. 72 percent of the benefit goes to Americans making $50,000 or less.

In dollar terms, repealing the third year would cost a taxpayer at $15,000 income $112 in FY 1984; at $20,000 income, it would cost $203 in 1984; at $30,000 income, taxes would be $410 higher in 1984.

C. Indexing. Indexing is crucial not just because it provides tax relief, but because it insures truth in government: tax changes will have to be voted on openly and directly, rather than having Congress rely on inflation to raise revenues through the deception of bracket creep. Whatever attitude you take on the question of generating new revenues, it makes sense to keep indexing in place.

In addition, indexing is an important symbol of our commitment to fight inflation. Repealing it only generates significant revenues if you assume inflation will persist at fairly high levels. If we de-index, we send a signal that we are not committed to beating inflation--and that means bad news for financial markets, for interest rates, and for consumers and investors alike.

Finally, the tax relief provided by indexing is real and sustained. Indexing means $98 billion in tax relief between 1985 and 1988, assuming modest inflation. $78 billion of that goes to taxpayers earning under $50,000. This group now pays about 66 percent of taxes, but will get 80 percent of the benefit--proving that indexing is a truly progressive tax reform.

A median income family of four would pay $1,000 in additional taxes between 1985 and 1988 if indexing were repealed (assuming they earn $24,000 in 1982). Remember that consumers are homebuyers as well, and their after-tax income is as important as interest rates in determining whether they will buy.

V. Issues of Continuing Concern

A number of issues that have been around for some time may receive attention from the 98th Congress.

1. 6-month holding period. Efforts to reduce the capital gains holding period to 6 months will continue. There is

very strong support for this change, because it can give a boost to capital markets at a time when greater savings and investment is vitally important to sustained economic recovery. This change was approved by the House in 1981 and by the Senate on three separate occasions in 1982, so it is time to get it enacted into law.

2. Enterprise Zones. The Senate has approved a modified version of the administration's enterprise zone proposal. A major question remains whether the House will take an interest in the idea, which they did not in the 97th Congress: but at least the Senate action, as part of the withholding repeal package, will get the attention of the House.

3. DISC. While no specific DISC proposal was made in the 97th Congress, the issue was extensively discussed--particularly the question of legality under the GATT. The Administration has committed itself to bringing the DISC into conformity with the GATT and will submit legislation to do so shortly.

5. Caribbean Basin. As part of the withholding repeal package, the Senate also approved the President's proposal for trade and tax incentives to boost economic activity in the Caribbean nations. The Ways and Means Committee is marking up this week.

VI. Social Security

A. The National Commission developed a bipartisan package that deserves support. It is not perfect, and everyone had to swallow hard on some items: that is the cost of reaching agreement.

B. The work of the Commission made clear that we had to confront the crisis in social security. The Commission agreed that $150-$200 billion is needed between 1983 and 1989 to ensure the solvency of the system through 1990. This means providing about a 15 percent reserve ratio by 1990 under the pessimistic--some would say realistic--assumptions.

C. The bipartisan package, includes a 6-month delay in cost-of-living adjustments, partial acceleration of scheduled payroll tax increases, coverage of new Federal workers and non-profit organizations, and partial taxation of benefits for higher-income beneficiaries.

D. We cannot forget that the payroll tax burden is already heavy and scheduled to increase, and the confidence of young people is critically low. The long-term deficit can be reduced considerably by very gradually slowing the growth of the system as people come on to the rolls in the future. The bill raises the retirement age to 67, again very gradually, for people retiring some 20 or 30 years from now. Ample time is available for people to adjust their savings and retirement decisions.

VII. . Trade

A. Trade deficit is too large. The size of our trade deficit (which is now projected at $60 billion or more in merchandise trade and $30 billion in current account) alone means Congress will continue to look hard for ways to reform our trade policy. The system of multilateral arrangements has been called into serious question as many believe it fails to meet our needs. Many voters and members of Congress will want to see us approach more of our trade problems on a bilateral basis. The average American simply does not understand why Japanese cars and TV's sell well here but American cigarettes, beef, baseball bats, and cosmetics cannot be sold in Japan. Remedies for this type of situation are certain to be a major focus of attention in this Congress.

B. Export issues. Unfortunately, the GATT ministerial failed to make progress on the question of foreign subsidies for agricultural exports. This will continue if pressure from Congress to resolve this situation through negotiation or for other export promotion actions like the recent wheat flour sale to Egypt. S. 822, recently passed by the Agricultural Committee, would establish several export promotion activities.

I support efforts to equalize the rules under which trade is conducted. This does not mean trade war, but does mean seeking to expand East-West trade, developing a viable substitute for DISC, utilizing Ex-Im Bank resources more adeptly, and enacting the trade reciprocity bill that the Senate approved April 21. Fair access to markets must be a two-way street, and Congress will be under considerable pressure to see that that is so.

C. Import issues. As you know, the House passed "local content" legislation at the end of the last Congress. That is a drastic proposal and likely to be counterproductive in the long run if our goal is to increase access to markets and to gain maximum benefit from the mutual advantages of international trade. There may be other areas, however, where we might make adjustments: in considering extension of the Generalized System of Preferences, there may be an interest on the part of some members of the Finance Committee to seek some reciprocal benefits from the major GSP beneficiaries. There appears to be substantial support for the trade provisions of the President's Carribean Basin Initiative, however, as those countries offer U.S. exporters a potentially strong market. It may be difficult to renew the President's general authority to negotiate tariff reductions on a limited basis. It is a good sign that the Japanese have agreed to continue voluntarily to restrain their automobile imports to this market for a third year until the domestic industry has had an adequate time to get back on its feet.

D. Clearly the heat is on when it comes to seeing that American producers get fair treatment under our system of international trade. If we choose our battles carefully to secure an appropriate response from our trading partners, we have an opportunity to making trade freer and fairer, to the advantage of everyone. But we must avoid the two extremes of allowing the world to think only the U.S. will play by the rules of free trade, regardless of disadvantage to our citizens; or, on the other hand, taking extreme unilateral actions that may look good politically but that, in the long run, will provoke severe reaction and deprive us of market opportunities. We need just the right amount of leverage to open more doors, not have them slammed in our face.

VI. Conclusion

The months and years ahead must not be dominated by rigid ideologies on either side--but neither can the President or the Republican leadership be expected to cast aside the principles of Government the American people so soundly endorsed in 1980. Those principles--a more restrained Government, a freer economy, greater accountability to the American people--are as valid today as they ever were, and there is no indication that the people have changed their commitment to these same principles. Guided by these principles, we will try to work together to build on the sound foundation for recovery that has already been laid.