United States Senate

COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

Dec. 15

December 14, 1983

M E M O R A N D U M

TO: SENATOR DOLE

FROM: GEORGE PIELER

SUBJECT: BANK OF ILLINOIS SEMINAR SPEECH

Attached are materials for the above talk. The group is interested in the budget, inflation, interest rates and the general business health of the country.

Attached are talking points on what the deficit means to average Americans, general deficit talking points, talking points on monetary policy and on international finance.

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Attachments

WHAT THE DEFICIT MEANS TO AMERICANS

- It is difficult to conceptualize the size of the projected deficit unless it is reduced to a personal level. The public debt now stands at about $6,000 for every man, woman and child in the U.S. If nothing is done to reduce the deficit over the next five years, the debt will grow to over $10,000 per person. At this level, by 1989 it will take about 50% of all Americans' personal income tax payments to pay the Federal Government's interest bill.

- Another way to relate tax cuts to the deficit problem is to look at the net tax cut from ERTA and TERFRA, combined. The total tax reduction after both those bills, over a 3-year period, is $344 billion. But with deficits near $200 billion in each of those years for a total of $600 billion--nearly <u>twice</u> the tax cut is added to the National debt.

- The $250 billion interest cost in 1989 costs out to $1100 per person. That represents nearly 40% of each person's annual expenditures for food--probably the most important factor in the average family's budget.

- Unless deficits are reduced, by 1989 just the <u>annual</u> interest cost on the national debt will be $250 billion. That amount--about $1,100 per person--is nearly <u>four</u> times the amount taxes were reduced per taxpayer in 1981 over a five-year period. (5-year individual tax reduction from ERTA was $631 billion, or about $2,745 per American.)

- Even now the interest on the National debt, in FY 1984, costs nearly as much to pay as the 1981 tax cut returns to taxpayers in 1984--$120 billion for the tax cut in 1984, $110 billion to pay interest on the debt. That is about $1,000 per taxpayer in annual interest expense.

- Many Americans will find home-buying more difficult with higher deficits. Consider a family purchasing a home at today's current interest rate, averaging about 12-1/2%, with a $55,000 mortgage. If the deficits push interest rates up, total interest costs over the 30 year term will be $15,500 more for each one ~~percentage point~~ increase.

- The deficit also feeds upon itself, making the next year's budgeting that much harder. Each year of $200 billion deficits adds about $15 billion in interest cost to the following year's spending levels. This amount in nearly the size of the entire medicaid program.

- Unless we act on the deficit, the National debt will increase $1.2 trillion over the next 6 years. That is 1-1/2 times the <u>total</u> five-year cost of the 1981 tax cut (before TEFRA). This addition to the National debt will have to be financed in some way--either in higher inflation or interest cost, or larger future tax increases--that undermines the benefits of the tax cut.

TALKING POINTS ON REDUCING THE DEFICIT NOW

- In its midyear budget review, the Reagan Administration estimated that the Federal budget deficit would be roughly $200 billion for each of the next 6 years.

- Over that 6-year period, unless something is changed these deficits will cumulate to $1.2 trillion--just about doubling the national debt.

- Without action on the deficit, deficits for each of the next 6 years will exceed 4 percent of our Gross National Product--that is a postwar record previously matched only in 1976.

- Assuming a $200 billion deficit has to be financed at a 10 percent interest rate--a reasonable assumption given prevailing conditions--the interest alone on a deficit of this size amounts to $20 billion. That is enough to finance all of the Medicaid program at current funding--it is 2-1/2 times the cost of the AFDC program, or of the SSI program--it is over four times the cost of General Revenue Sharing.

- Over the next 5 years financing costs for the interest on this additional debt would amount to $100 billion.

- In addition, if nothing is done to prevent this $1.2 trillion addition to the national debt, interest payments on this additional debt alone would amount to $100 billion a year after 1988. That is nearly double the present cost of interest on the national debt, and is equal to over 20 percent of all the personal tax revenue we expect to collect in 1988.

- All of this additional debt, and the interest we pay on it, has to be paid for in some way--in higher interest premiums or inflation, in higher taxes, or more severe spending cuts. The longer we wait, the higher the cost of deficit reduction will be.

- Lowering outyear deficits now should help bring down interest rates; that can stimulate investment to keep recovery going. That means a stronger economy in the outyears when further spending reductions and tax increases we enact now would be coming in place. But absent such a boost to the economy, the economy may be too stagnant in those outyears to sustain a sudden restraint on fiscal policy--which means we would be compounding the problem and risking a downward economic spiral.

- o Interest rates that are kept high by the size of anticipated deficits matter not just for government finance and the taxpayer--they matter for the homebuyer, who has seen rates creep back up to the 13+ percent range, and for the small businessman or entrepeneur trying to get started. High interest rates can cut short a promising economic future for everyone.

- o The $1.2 trillion increase in the national debt over the next six years will add $5,217.39 in new debt for each man, woman and child now living in the U.S. This would come on top of the over $6,000 debt per capita already outstanding.

- o Escalating deficits leading to higher interest rates do not just pose the threat of mortgaging our future. Higher interest rates mean lower capital formation and less long-term growth; more pressure for raising domestic barriers to free trade; and bad news for our basic industries, because the need for upgrading heavy plant and equipment means those industries are very sensitive to interest costs.

- o In addition, the stronger dollar that tends to result from higher U.S. interest rates makes it more difficult for American companies to compete with low-cost imports and to secure a foothold in overseas markets.

- o High deficits and interest rates retard capital formation and pose a real risk of 'disinvestment' in the United States, implying a much more fragile American economy. A low-growth path could condemn many citizens to poverty who might ottherwise be able to find productive and useful employment.

TALKING POINTS ON DEFICITS

- o As Martin Feldstein, President Reagan's chief economic adviser, has said, if we don't do anything about controlling this deficit now, it will cost one-fifth of all personal income taxes collected by the Federal Government just to service the interest costs of the $1 trillion of new debt accumulated over the next five years.

- o If we wait just one year to do something about controlling the increase in the deficit, it will require deeper spending cuts and higher tax increases.

  For every dollar in spending cuts needed this year, it will require 1.10 next year.

  For every dollar we raise taxes this year to accomodate the deficit, we will have to raise them $1.10 next year.

- Since 1981, we have brought about spending cuts amounting to $109 billion for the 1983, 1984 and 1985 budget years.

  But over the same period of time, we have seen the budget deficit increase by $91 billion.

  That means that the deficit has wiped out 83 percent of all the savings we have realized through our reductions in Federal spending.

November 29, 1983

BASIC COMPONENTS OF PROPOSED FINANCE COMMITTEE DEFICIT REDUCTION PACKAGE

Overview

- The Finance Committee has aimed for $150 billion in total deficit reduction over the next 4 fiscal years, with most of the savings coming in fiscal years 1985 through 1987.

- The package will have at least one dollar in guaranteed spending cuts for each dollar of revenue increases.

- The Finance Committee will undertake to enact one-half of the spending reductions, and look to the other Senate Committees to produce an equivalent amount of savings.

- Any new revenue increases (other than pure loophole closers) will be expressly contingent on a certification that spending cuts have been achieved and will be triggered off if Congress later reneges on these spending cuts.

I. Spending Reduction Proposals Within the Jurisdiction of the Senate Finance Committee

The total package, including provisions totalling $5.3 billion in savings incorporated in the Reconciliation Act of 1983 as reported by the Budget Committee, would result in a savings of $38 billion over 4 years. The majority of the proposals would have an effective date of January 1, 1985.

- Rounding of Social Security COLA. Proposal modifies the COLA paid in 1985, 1986 and 1987 by rounding the increase to the next lower whole percentage amount.

  FY 1984-87: $5.1 billion

- Modify timing and rate of increase in Part B Premium. The premium would be permitted to increase each year until it reached 35% by 1990. (Modification of 1983 Administration proposal)

  FY 1984-87: $2.9 billion

- Delay In Initial Eligibility for Medicare Entitlements. Delays eligibility for both Parts A and B of Medicare to the first day of the month following the month of the individual's 65th birthday. (1983 Administration proposal)

FY 1984-87: $1.0 billion

- Restructure Medicare Cost Sharing/Apply Co-Pays to Hospital Days and Provide Unlimited Hospital Days. Modifies cost sharing on hospital stays and nursing home stays and provides catastrophic protection under Part A of Medicare. (Modification of 1983 Administration proposal)

  FY 1984-87: $1.6 billion

- Modification of Working Aged Provision. Modifies 1982 provision which made Medicare benefits secondary to benefits under employer group health plans. (Strongly supported by OMB and HHS)

  FY 1984-87: $1.2 billion

- Participating Physician Program. Freezes certain physician fees for 2 years and creates incentives for physicians to take assignment. (Modification of 1983 Administration proposal)

  FY 1984-87: $2.2 billion

- Limit Increase in Hospital Costs Per Case. Limits increases in hospital costs per case to the increase in the hospital market basket price index. (Modification of 1983 Administration proposal)

  FY 1984-87: $2.9 billion

- Fee Schedule for Clinical Laboratory Services. Establishes fee schedule for payment to all laboratories for services provided to Medicare patients.

  FY1984-87: $0.9 billion

- Extend Reduction in Federal Payments. Extends the existing reduction in Federal Medicaid payments to States for 2 years. (Modification of 1983 Administration proposal)

  FY 1984-87: $1.0 billion

- Debt Service. The reduced outlays and increased revenues would decrease interest on the Federal debt by $13.9 billion over FY 1984-87.

II. Revenue Provisions

The total package, including provisions totalling $21.1 billion incorporated in the Omnibus Reconciliation Act of 1983 as reported by the Budget Committee, would increase revenues by $72.8 billion over 4 years.

A. Contingent Revenue Increases

The following revenue provisions, totalling $59.8 billion over 4 years, would take effect on January 1, 1985 only upon verification that the required reductions in Federal outlays have, in fact, been achieved:

- Energy Tax. A two and one-half percent tax would be imposed on the sale of sources of energy consumed in the United States.

  The President's 1984 budget included a $5 per barrel excise tax on domestic and imported oil.

  FY 1984-87: $20.9 billion

- High Income Individual Surchage. A surcharge of two and one-half percent would be imposed on income above approximately $60,000 for joint returns ($42,000 for single returns).

  The President's 1984 budget included a surcharge on individuals approximately equivalent to one percent of taxable income.

  FY 1984-87: $5.1 billion

- Tax on Corporate Economic Income. A two and one-half percent tax would be imposed on the economic income (over $100,000) of corporations.

  The President's 1984 budget included a surcharge on corporations of approximately one percent of taxable income.

  FY 1984-87: $14.5 billion

- Rounding Down of Indexing. Indexing of brackets, exemptions, and the zero bracket amount would be computed with reference to the Consumer Price Index rounded down to the next lower full percentage point. This proposal would be consistent with the modification of Social Security COLA's.

  FY 1984-87: $5.6 billion

- Zero-Bracket Amount (ZBA) Increased. The ZBA (formerly the "standard deduction") would be increased by $100 ($200 for joint returns) in 1985. Heads of households would be given a ZBA halfway between simple and married taxpayers, with a new rate schedule.

FY 1984-87: $7.4 billion

B. Treasury-Supported Revenue Reforms.

The deficit reduction package would include proposals, totalling $13 billion, supported by Treasury testimony to the Finance Committee limiting tax shelters and accounting abuses and reforming the taxation of corporations.

FY 1984-87: $13.0 billion

III. Summary

	Fiscal Years 1984-1987
Spending Restraint Already Agreed to by the Finance Committee	5.3
Spending Restraint Proposals Within Finance Committee Jurisdiction Contained in Proposed Package	32.7
Spending Restraint Requirements Within the Jurisdiction of Other Committees	37.5
Revenue Increase Already Agreed to by the Finance Committee	21.1
Revenue Increase Proposals in Proposed Package	51.7
TOTAL	148.3

Monetary Policy and the Federal Reserve

• There has been, and will continue to be, considerable debate over Federal Reserve policy and its implications for inflation, interest rates, investment and growth. But one thing virtually everyone agrees on: Chairman Volcker and the Fed have had the only effective anti-inflation game in town. It is largely due to their efforts, with substantial support from President Reagan, that inflation has been brought down from 13 percent to around 3 or 4 percent. The question now confronting all economic policymakers--whether they deal with monetary or fiscal policy--is how to sustain economic recovery and growth without abandoning the dramatic gains won against inflation.

• There is also a widespread belief that the Fed overdid it somewhat in 1981, tightening money too much too soon in an effort to beat inflation. It may also have overcompensated somewhat in 1982, to try to get back on a steady path consistent with economic recovery. The goal now should be to maintain a stable course, keeping money growing at a moderate pace to accommodate growth <u>without</u> accommodating or encouraging inflation. And that is what the Fed says it is trying to do.

• There are always the perennial Fed-watchers, who say Chairman Volcker is trying to tighten too much because he fears rapid growth will lead to inflation, or that he is going to loosen up too much in an election year. Neither case can be proven, and all we can do is look for the Fed to follow a consistent course over time. A jump in interest rates <u>or</u> inflation would be cause for substantial concern, and in either event we would want to take a close look at what the Fed is doing. But the last thing we need is a bigger role for Congress in setting monetary policy--political control of that kind is not likely to lead to enlightened policy-making on questions of money and credit.

• We can make the job of following a consistent, stable monetary policy easier by regaining control of the fiscal side of the policy equation. Fiscal policy is in danger of going out of control, if $200 billion+ deficits are the way of the future. With lower deficits, a consistent monetary policy is more likely to be accompanied by lower interest rates and a smoother pattern of investment that will help sustain recovery in the years ahead.

Money, Deficits, and International Finance

- It is clear that high interest rates and a stable dollar attract investment from abroad into the U.S. This is no doubt a result of many factors, including Federal Reserve policy, expansive U.S. budget deficits, and concerns on the international scene that make the U.S. seem to be a safe haven.

- The attraction of capital into our country has a number of consequences. One is that it helps finance our national debt, so that high budget deficits have not yet resulted in the kind of 'crowding out' or higher interest rates that many analysts fear. But it is not clear how long that day of reckoning can be postponed if our fiscal imbalance is not corrected. Financing our debt abroad, plus the effects of tax cuts and a stock market boom that reduce credit needs in the private sector, have helped so far. But as other countries experience economic recovery the situation could change significantly.

- The attractiveness of the United States for investment also tends to alter the balance of trade. A strong dollar makes it more difficult for U.S. producers to sell their goods overseas, and easier for foreign producers to market goods here. This means, at least in the sort run, slower growth and fewer jobs in U.S. companies that depend heavily on export markets. But it also means lower costs to U.S. consumers because of competition from imported goods, and increased incentives for U.S. producers to keep costs down and be more efficient. So there is both an impediment to growth and an anti-inflationary effect.

- In the long run the present situation--large U.S. budget deficits, restrictive or moderate monetary policy, and a large U.S. trade deficit--probably cannot be sustained. But while there will have to be a correction, it need not be a drastic or sudden change. We should not forget our recent history, when double-digit inflation and other problems caused the decline of the dollar and undermined our ability to generate the capital needed for stable growth. Lower deficits, low inflation, and higher rates of capital formation and investment remain the key to a stable, growing economy. That is why we need to tackle the deficit problem <u>now</u>, encourage the Federal Reserve to run steady course without throttling recovery, and choose tax and spending policies that foster savings and investment. And there are growing signs that our political leadership is willing to face up to the deficit problem, even in an election year.

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December 14, 1983

M E M O R A N D U M

TO: SENATOR DOLE

FROM: DON SUSSWEIN

SUBJECT: UPDATE ON PRE-1981 COMMODITY TAX STRADDLES

Disputed Tax Cases

A number of disputed tax cases are pending involving tax straddles used by professional commodity traders to "roll" taxable income from pre-1981 commodity trading into 1981. The 1981 statutory changes preclude any deferral beyond 1981 using regulated future contracts, while imposing a 32% tax rate on the accumulated, deferred income "rolled" into 1981. Despite the fact that the 1981 law stops the practice of commodity tax straddles, and requires all accumulated, deferred commodity income to be recognized, the IRS is continuing to challenge the pre-1981 straddles, in part to establish certain common law legal principles and in part to raise revenue by subjecting the deferred income to a 70% tax rate (applicable before 1981) instead of the 32% tax rate applicable in 1981.

Proposed Legislation

Some traders have requested legislation to codify, on a retroactive basis, a recent unanimous decision of the U.S. Tax Court (Commissioner v. Smith) that rejected many of the legal theories IRS intends to use in the pending trader cases. Treasury opposes the legislation, since the IRS has refused to acquiesce in the Smith opinion. Because this Tax Court case involved investors, not professional traders, Treasury and IRS believe the Tax Court, or an appellate court, might reach a different result in a case involving traders.

Discussions Before Recess

Discussions conducted prior to recess produced no agreement between Treasury and the traders, although a provision was added to the proposed deficit reduction package requiring Treasury to report in six months on progress made reducing the backlog of these cases.

Based on staff discussions, we believe the traders would be willing to limit the relief they seek to traders who did not engage in stock option straddles in 1981 (under which they could have avoided the 1981 anti-straddles rules), and might also be willing to consider applying a tax rate somewhat higher than 32% to the gain recognized in 1981, in exchange for the certainty of being able to rely on the Smith case. Such a compromise would be analogous to litigation settlements where a monetary dispute is compromised on the basis of the parties' likelihood of prevailing in court. However Treasury categorically rejected such a staff proposal, even using the maximum 50% tax rate. Thus, unless Treasury adopts a more flexible position, this approach may not be productive.

Treasury has also rejected a proposal favored by the traders to set up a test case or a consolidated case which Treasury would agree to follow, after having a fair opportunity to test their legal theories in a case involving professional traders.

Treasury's only counter-offer was to provide the relief sought by the traders, in exchange for raising the 32% tax rate on futures contracts to 40% for all transactions in the future. The traders rejected this offer. It is noteworthy that raising the tax rate may not raise revenue in future years, since in commodities trading every gain is matched by a corresponding loss and the 32% tax rate reduces loss deductions as well as gains. However, traders tend to be on the winning "gain" side of most transactions, while other investors tend to be on the "loss" side. For this reason the traders prefer the low rate, and feel that giving up their favored tax rate across-the-board is too high a price to settle several hundred tax cases.

Future Negotiations

The staff will soon be meeting with the options industry to discuss their concerns with the Finance Committee reconciliation provisions extending the 32% tax rate to options on futures, but not to other options. Since the options industry and the futures industry are in disagreement on this issue, these discussions may provide an opportunity to discuss again the pre-1981 commodity issue with the Treasury Department.