United States Senate

COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

January 25, 1984

TO: Senator Dole

FROM: George Pieler

SUBJECT: Talk to National Association of Independent Colleges and Universities

Attached are materials for your talk to NAICU at 9:00 a.m. Thursday, January 26.

Included are materials on the deficit and the economy, and discussions of issues that may be of interest to the group--Finance Committee proposal to impose a 5-year holding period for gifts of appreciated property, IDBs with an emphasis on use for student loans, and education savings accounts.

There also might be a few questions on treatment of tuition benefits as a fringe benefit. If the Congress proceeds to extend the moratorium on taxing fringe benefits for another two years, the issue would be covered for now. The Ways and Means tax bill, of course, proposes substantive rules on fringe benefits. Those rules would still permit 'tuition remission' programs, programs whereby, e.g., a faculty member may get free education for his or her children at the institution where employed, or at a cooperating institution with a similar program. However, under the Ways and Means bill, anti-discrimination requirements would have to be met for the benefit to go tax-free. This would mean that the same benefit would have to be provided to all employees, not just the top-salaried faculty, for example. Whether this is a workable rule, or an effective device for guaranteeing even-handed treatment in providing tuition benefits, is something we would want to examine.

Also in the area of fringes, you may recall that you promised Senator Moynihan that, when we address fringe benefits, you would work to resolve the uncertainty on the question of taxing as a fringe benefit subsidized housing provided to faculty members. Currently the IRS view is that subsidized housing does not come under the fringe benefit moratorium because of a pre-moratorium court case holding that free housing was compensation subject to withholding. Thus a moratorium extension would have to make special provision for this issue.

Attachments

REMARKS OF SENATOR DOLE

NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES

Thursday, January 26, 1984--9:00 A.M.--Hyatt Regency

What is the Federal deficit likely to be?

- The estimates of future Federal deficits are quite sensitive to one's economic assumptions. Yet even under the most optimistic of economic assumptions, the deficit will remain at historically high $200 billion levels over the foreseeable future, unless drastic action is taken.

- Assuming an extremely strong recovery (4% real growth of GNP) is sustained over the next few years and all of the Administration's proposed spending cuts are made, the deficits are still projected to be:

FY 1985	FY 1986	FY 1987	FY 1988
$185 billion	$195 billion	$199 billion	$179 billion

- If economic growth is not so strong (3% real GNP growth) and interest rates are slightly higher (9% T-bill rate), and Administration's spending cuts are <u>not</u> enacted, the projects deficits would be:

FY 1985	FY 1986	FY 1987	FY 1988
$202.6 billion	$236.7 billion	$270 billion	$290.1 billion

- If we have an economic downturn during this period, we may be facing $300 plus billion deficits.

Why worry about the deficit--What does it mean to the average American?

- If nothing is done to reduce deficit spending over the next five years, the total Federal debt will nearly double to over $10,000 for every man, woman and child in America.

- At this level, by 1989 it will take one-half of all Americans' personal income tax payments just to pay the Federal Government's interest bill.

- By 1989 the annual Federal interest cost will amount to $250 billion--about $1,100 for every American.

- That $1,100 per person interest cost is equal to 40% of each person's annual expenditure for food.

- Virtually all economists agree that the sustained enormous deficits that we are facing will be economically harmful.

- 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.

- All Americans will directly feel the results of high deficits if they lose jobs as a result of a business slowdown resulting from a crowding out of private investment, or if they lose jobs to imported products made more competitive because of an abnormally strong dollar or if they end up paying higher prices because inflation is rekindled.

<u>What do you think the Adminstration will propose in its FY 1985 budget to deal the with deficits?</u>

- Clearly the Administration will repropose many of the domestic spending cuts from its 1984 budget that have not been acted upon.

- Based on the figures I have seen, the Administration will propose only about $6 billion in net domestic cuts for FY 1985, but that figure is larger in the out years:

FY 1985	FY 1986	FY 1987	FY 1988
$5.6 billion	$13.7 billion	$17.0 billion	$22.1 billion

- Unfortunately, I am afraid that the effect of these domestic spending cuts will be undercut by proposed increases in defense spending.

- On the tax side, I do not think it is likely that the Administration will propose some form of contingency tax increase like that included in last year's budget.

- Thus, at this point I do not see very much in the way of deficit reduction included in the FY 1985 budget Adminstration submission.

What about defense spending?

o It is expected the Administration will reccommend $305 billion in defense spending for FY 1985--a 13% real increase over the 1984 defense spending level.

o This sharp increase in defense spending is $16 billion over the substantial increase provided for FY 1985 in the most recent Congressional budget resolution.

o Over the period FY 1985-1987, the Administration's defense recommendation is about $65 billion higher than the 5% real growth path that Congress last year set as adequate for a strong defense.

o The Adminstration's defense recommendation is a first offer that sets its opening bargaining position. I believe that the final defense number for FY 1985 will be close to the $289 billion figure contained in last year's budget resolution.

o Even at a $289 billion level, defense spending will have increased 91% since 1981, the first year of the Reagan Presidency.

WHY SHOULD WE ACT THIS YEAR ON THE DEFICIT

o If we fail to deal with the deficit now, the problem will become worse. Current projections showing deficits holding in the range of $200 billion probably are optimistic, as they are based upon assumption of steady economic growth through 1989. However, postwar experience suggests that the average recovery lasts only 3 years, making a recession in 1985 or 1986 likely.

o If we postpone action until 1985 and we do suffer another recession, the deficits would then hit the $300-$400 billion range. At that point, it may be difficult to cut the deficit without further weakening the economy. Our choices would become very difficult indeed.

o Of course, failure to reduce the deficit in 1984 makes a recession likely to come sooner, as interest rates are forced up by private credit demands clashing with Treasury borrowing needs.

o By postponing action of the deficit, we increase the risk of recession. The average increase in the unemployment rate during a postwar recession is about three points, or three million jobs. By acting to reduce the deficit, we can significantly lower the risk that three million workers will lose their jobs in 1985 and 1986.

- The rise in interest rates will depress auto sales, housing starts, and capital goods orders. It is widely recognized that sustained economic recovery will be impossible unless these key sectors are healthy.

- Alternatively, the Fed could offset the deficits' impact on interest rates by "monetizing" the debt, leading to a resurgence of inflation in 1985. If we do nothing, we will force the Fed to choose between high interest rates and recession, or inflation.

- Failure to reduce the deficits in 1984 may also depress the stock market. A key factor in determining equity and bond prices is investors' confidence that Congress and the Administration can produce a sound fiscal policy. If we send the signal that the deficit problem is secondary to politics, equity and bond prices may fall.

- The exploding cost of servicing the Federal debt will make controlling spending more difficult each year, unless the deficits are reduced soon. Each year that we add $200 billion in new Federal debt adds about $15 billion to the next year's interest costs.

- The economy is now on a path where more and more of its resources go just to pay off the debt. According to economist Lawrence Summers, "It's a case where the miracle of compounding (interest) works against you."

- In 1976 net interest accounted for just 7% of total outlays But if we do nothing, by 1988 the total Federal debt will be more than half of total GNP, and the net interest cost of servicing this debt will reach 14% of all spending. Each year that we do nothing, the share of Federal spending that we can control gets smaller.

- Recent studies indicate that current and prospective budget deficits may have helped to overvalue the American dollar. If the deficits are not reduced, the problem of overvaluation could become worse, weakening the competitive position of American exports and costing the U.S. jobs in such industries as steel, electronics, and agriculture.

RECOVERY--WHAT PROGRESS HAVE WE MADE

Strength of recovery

- A strong recovery is on track and appears to be moderating to a pace that can be sustained in the years ahead. As an indication, look at the expansion of real gross national product. It grew by

9.7% in the second quarter of 1983, 7.9% in the third quarter, and an estimated 4.5% in the fourth quarter. By this measure, the recovery is the strongest since 1961.

- o Housing starts are running at a rate of about 1.7 million units a year, and new home sales are up by 91% over the recession low.

- o Industrial output in 1983 rose 6.5%, and factory utilization is up to 79.4%--the highest level in two years, and close to the normal capacity of 82%.

- o The Commerce Department's survey of business plans for 1984 show that business plans to increase capital investment by 9.4%--this is a rate about 2% higher than that seen at comparable points in previous postwar recoveries.

Inflation

- o The best news about this recovery is that it is noninflationary. In 1983 the producer price index rost just 0.6%--the lowest increase since 1964. The CPI for 1983 was 3.8%, the lowest since 1972. Continued moderation in producer prices indicates low inflation will continue.

Creating Jobs

- o People are going back to work, and the pace of job creation has been unusually high for a postwar recovery. On January 6 the Labor Department announced the civilian unemployment rate dropped from 8.4% to 8.2% in December. Overall, this means unemployment has dropped 2.5 percentage points over the past year.

- o The continued strength of the recovery shows that recent growth in employment has not just been a statistical fluke, but shows a real turnaround in the labor market. Unemployment fell 230,000 in December, and there have been 4 million jobs created in the last year.

- o What is more, the growth in jobs is broad-based. While manufacturing industries showed the most dramatic gains, all industries other than government and agriculture showed dramatic drops in unemployment.

CONTRIBUTIONS OF APPRECIATED PROPERTY

- One tax shelter abuse that has received considerable attention is the overvaluation of donations of appreciated property to charitable institutions.

- In a typical scheme, an investor will buy an art object for $5,000 cash but an apraiser will value it at 12 times the price. The owner holds the object for a year to obtain capital gains treatment, then donates it to charity and takes a $60,000 deduction.

- Statistics from the IRS illustrate that such practices are not isolated. In the past eight years, the IRS's art advisory panel, which reviews appraisals of contributions of artwork reported on audited returns, found overvaluations of $24 million out of $141 million of donations reviewed.

- Overvaluation problems are also evident with respect to gifts of manuscripts, closely held stock, and real estate holdings.

- Generally the real property donated is not a condominium or home that cna be easily valued. For example, controversy has arisen over the valuation of 16 acres of land donated to a college in Florida, and over the appraisal of silver mining interests donated to Brigham Young University.

- These abuses are particularly evident when, as is often the case, the donations are made soon after the property is acquired by the donor at a much lower cost.

- In the deficit reduction proposals made public last November, a suggested cure for this abuse was to limit a charitable deduction contribution to the donor's basis in the property, unless such property has been held for at least five years.

- This 5-year holding period rule was suggested by the President's Committee on the Arts and Humanities, and Treasury supports the recommendations.

- Currently, the Finance Committee is reviewing this proposal together with two other proposals of the President's Committee. The other proposals would (1) allow individuals to contribute 75 percent of their adjusted gross income to charities, rather than the current 50 percent, and (2) extend the carryover period for deductions from 5 to 15 years.

- The Committee, Treasury, and the President's Committee are working to find a combination of these proposals that will be revenue neutral. This may mean that the proposed 75 adjusted gross income level may be reduced to a number between 50 and 75 percent.

- A holding period limitation has a number of advantages over other suggested proposals for dealing with the problem. The limit is easy to administer and understand. Reviews of overvaluation are more dependent on a return's being audited, and are costly to the IRS in terms of money and manpower.

- Some persons have argued that such a rule will deter charitable gifts. The rule may deter those individuals who purchase and then immediately donate property whose value is highly inflated, but these abuses should be curbed and do not appear to represent the bulk of donations to nonprofit organizations.

STUDENT LOAN BONDS

- Tax-exempt bonds can be used to help finance student loan programs operating under the Federal guaranteed student loan program.

- In recent years, the volume of these bonds has increased considerably. Long term issues increased from $100 million in 1976 to $400 million in 1980, and $1.7 billion in 1982. Current Treasury estimates are that the student loan volume will increase to $12 billion by 1988. This increase in student loan volume has led to proposed restrictions on the bonds.

- Student loan bonds are included in the proposed state-by-state volume caps contained in the House Ways and Means Committee tax bill. In addition, limits on excessive arbitrage on student loan bonds have been strongly recommended by Treasury, and are being considered by both tax writing committees.

- In addition, under a recent amendment to the Higher Education Act, student loan bonds now may not be issued unless the Education Department determines that their issuance is necessary to serve an unmet need for student loans.

- These legislative developments are troublesome to those concerned with guaranteeing access to student loans. But the developments are understandably attributable to legitimate concerns over the inefficiency of tax-exempt financing, and the possible availability of alternative ways to make sure that student loans are available.

- Since the Federal Government currently pays an interest rate subsidy on all student loans, the need for a second subsidy, provided indirectly through tax-exempt financing, has been questioned.

- In 1980, the Congress addressed this problem of a "double subsidy" by reducing the direct subsidy provided by the Education Department where student loans were financed with tax-exempt bonds. But it may make sense to consider the opposite approach -- that is, to <u>increase</u> the Education Department's direct subsidies where a real unmet need exists, rather than using inefficient, backdoor financing through the tax code.

- Clearly what is most needed is a comprehensive, efficient, long-term solution to the problem of providing adequate funding for student loans. Hopefully, the affected Congressional Committees and Executive Departments can cooperate to achieve this common goal.

EDUCATION SAVINGS ACCOUNTS

Proposal

The Dole bill, S. 16, would provide for tax-deferred savings accounts, similar to IRAs, to encourage savings for education. An account can be established for each child, and the parents and child may contribute up to $750 per year to the accounts, with a maximum of $3000 per family deductible each year: but only until the child reaches 21 or enrolls at qualified college or vocational school.

There will be no tax on amounts drawn from the accounts for use as tuition, fees, and reasonable living expenses--instead, amounts so spent will be included ratably in the child's income over 10 years beginning at age 25.

Administration proposal

Last year the Reagan administration proposed a similar incentive for educations savings. The main differences are that up to $1,000 per child could be set aside annually, and that while the account would be tax-exempt, contributions would not be deductible. Also, the tax break is limited to those making less than $60,000 a year, and a special penalty is provided for withdrawal of funds for noneducational purposes.

Revenue effect

(assuming 1-1-84 effective date)

(in billions)

FY 84 0.7 FY 85 2.4 FY 86 2.7 FY 87 3.2 FY 88 3.8

Talking points

- Our increasingly complex economy requires more sophisticated training, and more flexibility in the kinds of training and education offered. One way to address long-term employment problems is to tackle the skyrocketing cost of private education (up 11 percent in 1982). Education savings accounts can help meet this need by helping families get ready well in advance.

- Savings incentives for this purpose can be more effective than direct spending by the government because they target aid to those who want to take the initiative to help themselves, and they help foster additional net savings.

- Obviously revenue cost is a serious concern, but we ought to work to find the best, most efficient way to encourage higher education within the strict budget constraints we face.