

## REMARKS OF SENATOR DOLE

AKIN, GUMP, STRAUSS, HAUER & FELD

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### 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.

### 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.

proposed spending cuts and revenue proposals are enacted, the deficits are still projected to be:

<u>FY 1985</u>	<u>FY 1986</u>	<u>FY 1987</u>	<u>FY 1988</u>
\$180 billion	\$177 billion	\$180 billion	\$152 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 not enacted, the projected deficits would be:

<u>FY 1985</u>	<u>FY 1986</u>	<u>FY 1987</u>	<u>FY 1988</u>
\$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 should we act this year on the deficit

- 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.
- 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.
- 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.
- 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.

#### Deficit downpayment in 1984

- The President took the lead to begin a deficit-reduction effort in 1984 by calling for bipartisan negotiations on a package to reduce the deficit by \$100 billion over 3 years. Now he has worked with congressional Republicans to outline a \$150 billion package including defense savings (\$40 billion), nondefense cut

(\$43 billion), revenue increases (\$48 billion), and debt service savings (\$18 billion). As the President suggests, we can work with a variety of modest spending reductions, and tax reforms that raise revenue, to enact a significant deficit "downpayment" in 1984.

- Even though election-year politics makes it difficult to launch the kind of major assault on the deficit that we really need, that is no reason to do nothing. Making a noticeable dent in the deficit will make our job easier in the years ahead. Even more importantly, it will demonstrate that we can face up to the deficit problem even in an election year.
- The Senate has adopted the Finance Committee's proposals on spending and revenue options just within its jurisdiction that achieve about \$74 billion of the "downpayment" goal. To do that we draw on a number of proposals that have been on the table for some time, including some that were already in the legislative "pipeline":
  - Items included in the FY 1984 reconciliation bill, S. 2062
  - Treasury-endorsed proposals on tax shelters and other abuses
  - Administration -proposed spending cuts that were not followed through on last year
  - Administrative savings and other proposals made by the Grace Commission
  - Additional proposals considered in the Finance Committee last fall
- Target. With an overall goal of \$150 billion in savings, we can raise \$48 billion in revenue, save \$40 billion in defense, and save \$43 billion in nondefense programs, including \$24 billion in spending reduction from Finance Committee programs such as \$3.1 billion from Grace Commission recommendations, and \$9.6 billion in debt service savings. The remainder consists of additional spending changes and controls on appropriated funds.
- Feasibility. The key is to keep following the President's suggestion and concentrate on relatively non-contentious items, avoiding things like the third-year tax cut and indexing, mean-tested entitlements, social security, and the like. Our effort must be bipartisan and balanced to do the job: Democrats and Republicans alike will benefit by cooperating to take swift action on the deficit. Time is of the essence if we are to make a beginning this year.

- Initial Action. On February 23, the Finance Committee began action to reduce the deficit. The Committee bill agreed to by the Senate includes changes in health care programs that save over \$10 billion between now and 1987, the \$3.1 billion in Grace Commission savings, and \$9.6 billion in reduced debt service. In addition, the Senate agreed to tax reform and modest revenue raisers that generate about \$48 billion between now and 1987. The House has also approved a \$50 billion tax bill, so we are on our way.

### 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.
- Housing starts are running at a rate of about 2.2 million units a year, and jumped 11.2 % in February.
- Industrial output in 1983 rose 6.5%, and factory utilization is up to 80.7%--the highest level in two years, and close to the normal capacity of 82%.
- The Commerce Department's survey of business plans for 1984 show that business plans to increase capital investment by 16%--this is higher than that seen at comparable points in previous postwar recoveries.

#### Inflation

- The best news about this recovery is that it is noninflationary. In 1983 the producer price index rose 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

- 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% last November to 7.8% in February. Overall, this means unemployment has dropped 2.9 percentage points over the past year.

- 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 4.9 million jobs created in the last year.
- 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.

## HIGHLIGHTS OF SENATE DEFICIT REDUCTION DECISIONS

(Savings estimates are for period 1984-87,  
and include outlay savings in S. 2062)

### Spending Restraint

- Medicare Part B Premium. Stabilize the premium as a percent of program costs between 1985 and 1990. (\$1.2 billion)
- Delay initial Medicare eligibility until month after an individual's 65th birthday. (\$630 million)
- Working age. Non-working spouses age 65 to 69 could elect primary medical coverage under spouse's employer health plan rather than Medicare regardless of working spouse's age. (\$1.1 billion)
- Physican freeze. Continue until July 1986 a freeze on physican's fees for those unwilling to accept assignment for all services to Medicare patients. (\$2.8 billion)
- Fee schedule for lab services. Payments for clinical lab services would be held at 62 percent of prevailing charge levels through October 1987 (\$1.0 billion)
- Limit on hospital costs. For FY 1985 and FY 1986 increases in hospital cost payments under Medicare would be limited to one-half percent less than the hospital wage and price index increase. (\$1.1 billion)
- Grace Commission. Improved cash management techniques (e.g. faster deposits of receipts to the government), improving income verification procedures for benefit programs, and using IRS refund offsets to collect debts owed the government would be implemented. (\$3.1 billion)
- Debt service. \$9.6 billion.

### Revenue Increases

- Tax reform. New rules would be applied to limit tax shelters in such areas as partnership allocation of expenses and income interest deductions on discount obligations, transactions between related parties, current deductions for future liabilities, and corporate deductions for extraordinary dividends received. (\$10.2 billion)
- Tax benefits. Where a taxpayer receives a refund or other recovery for State taxes or other situations that previously gave rise to a deduction, the tax benefit portion of the deduction would be brought back into income first. (\$800 million)

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- Real Estate. Depreciation rules (20 years for all structures in FY 1984, 19 years in FY 1985, 18 years in FY 1986 and thereafter, new or used), and recapture rules for real property would be adjusted. (\$4.4 billion)
- Freeze. Expensing for small business investment would be frozen at \$5,000, the cost of used property eligible for the ITC would be frozen at \$125,000, and the foreign earned income exclusion would be frozen at \$80,000. (\$1.9 billion)
- Distilled Spirits. Federal excise tax would be increased \$2.00 per proof gallon (\$1.0 billion)
- Income Averaging. The base period for determining the income averaging threshold would be reduced to 3 years and the formula slightly modified. (\$1.6 billion)
- Earnings and Profits. The definition of earnings and profits would be modified so that it more closely reflects a corporation's economic income rather than its taxable income. This change will reduce a corporation's ability to pay tax-free dividends. (\$1.7 billion)
- Add-Ons. In addition to miscellaneous items, the Committee agreed to phase in spousal IRAs; an R&D package; foundation tax changes; extend the targeted jobs credit for 3 years; enterprise zones; increase the earned income credit; Foreign Sales Corporations; energy credit extension with credit reordering; and others.

March 23, 1984

PRELIMINARY ESTIMATES OF THE SENATE FINANCE COMMITTEE PACKAGE

<u>SPENDING</u>	1984-87 Total (Savings in \$ billions)	<u>Reconciliation Tax Provisions (S. 2062)</u>	1984-87 Total (In \$ billions)
- <u>Reconciliation (S. 2062)</u>			21.4
<u>Finance Committee provisions</u>	3.8	<u>Additional Revenue Items:</u>	
<u>Additional Spending Reductions</u>		Tax shelter, accounting abuse, and corporate reform	10.2
*Part B Premium	0.4	Tax Federal Home Loan Mortg. Corp.	0.3
*Delay in Initial Eligibility for Medicare	0.6	Tax benefit rule	0.8
Working Aged	1.1	Alcohol and tobacco collections	0.5
*Physician Freeze	0.8	Freeze ACRS expensing, ITC for used prop. and foreign income exclusion	1.9
Hospital Market Basket	1.1	Postpone finance lease rules	2.7
Lab Fee	0.9	Extend telephone-excise tax	3.2
Medicaid Reduction	1.4	Modification of Sec. 1231	0.2
Alcohol Rebate	0.9	Factoring of trade receivables	1.4
Revaluation of Assets	0.3	Source of shipping income	0.2
Lesser of costs of charges	0.3	Recharacterization of U.S. income as foreign source income	0.3
Competitive Bidding/Claims	0.1	Trust distributions	0.7
Round Part B Payments	0.2	Income averaging modification	1.6
SNF Rates	(0.1)	Delay in ESOP	0.4
Grace Commission	3.1	Corporate preference exclusion increase	0.5
Debt Service	9.6	Increase distilled spirits tax	1.0
Total	24.5	Deferred rent on real and taxable property	1.7
		Repeal dividend reinvestment	0.4
		Installment sale recapture rule	0.2
		20-year life for structures	4.2
		Other miscellaneous revenue increase proposals	2.6
		<u>Major Revenue Loss Provisions:</u>	
		Spousal IRAs	-.9
		Enterprise zones	-1.3
		R&D credit extension and expansion	-2.0
		R&D foreign source allocation	-0.2
		Targeted jobs tax credit	-1.6
		Life insurance tax change	-1.3
		Earned income tax credit	-0.4
		Mortgage revenue bond extension- IIB package	-0.6
		Grand Total	\$48.1

**Fairness: Equity Improvement  
In the Deficit Reduction Act**

The deficit reduction package approved by the Senate Finance Committee encompasses major improvements in the law designed to ensure more equitable treatment of all Americans, particularly those most in need. These provisions should not be overlooked as Congress focuses on the overriding goal of reducing the deficit.

- o **Tax Reforms and Limits on Tax Shelters.**--The bulk of the revenue raised under the bill comes through real tax reforms: limits on tax shelters, changes in special corporate provisions and accounting rules, and measures to make the tax system fairer by reducing special benefits to a privileged few. The only impact on the average taxpayer, of a \$48 billion total, is \$1 billion from a \$2 per proof gallon increase in the distilled spirits tax, and \$3.2 billion from a 3-year extension (not an increase) in the telephone tax. Specifically:

-The bill includes rules to limit the practice of taking large deductions for charitable donations of appreciated property. Some individuals have bought property, such as gems, at one price, but taken a deduction for a much higher value--and succeeded in doing so, because questions of valuation are complex. The bill includes new valuation and reporting requirements where a large valuation is claimed, an independent written appraisal, and a rule to disallow the charitable deduction where claimed value exceeds true value by at least 50 percent.

-A number of provisions in the bill address one of the major failings of the tax code, which has been to disregard the time value of money and the mismatching of income and deductions when parties to a transaction use different accounting methods for tax purposes. One of the loopholes the bill addresses in this area is the treatment of deferred rent leases. Under current law an accrual basis taxpayer can enter into a lease with a cash basis lessor where the rent is not to be paid for several years. The lessee may be able to accrue rent each year although rent may not actually be paid for several years. The lessor need not take the rent into income until paid, but is able to claim ACRS deductions to offset other income. The bill forces the lessor and lessee to treat the lease in a similar manner to preclude this loophole: the lessor must accrue rental income annually and will be treated as having loaned the rent back to the lessee at interest. Payments of rent in later years will be treated

in part as rent, and in part as payment of interest and principal on the loan.

-Several other provisions address various tax-motivated transactions involving buying and selling stock when companies pay large dividends. For example, last year Chrysler paid \$110 million in back dividends on its preferred stock. It is estimated that dividends cost the Treasury \$100 million because of the large number of tax-motivated trades in Chrysler preferred stock. This loophole would be closed by reducing for tax purposes the basis of a share of stock held by a corporate shareholder by the non-taxed portion of any nonliquidating extraordinary dividend for such share if the share is sold or exchanged before it has been held by the taxpayer more than 1 year.

-Another highly publicized tax gimmick whose advantages are eliminated by the bill is the oil and gas royalty trust, such as the one promoted for Gulf Oil by T. Boone Pickens. This is done generally by taxing a distributing corporation on any appreciation in value of property distributed in a non-liquidating distribution.

-The bill also eliminates the ability to defer tax through such transactions as stock option straddles and leveraged purchases of Treasury bills. These gimmicks are now widely used on Wall Street and elsewhere to achieve tax deferral.

-Another loophole addressed by the bill is the ability of partners to shift income and losses to a partner who has a lesser potential tax liability. This is done by providing a new rule governing allocations between partners when property is contributed to a partnership.

-A further loophole closed under the bill is a "sweetheart" deal between Puerto Rico and U.S. distillers. We have rebated excise taxes on liquor that was distilled elsewhere then shipped into Puerto Rico for a bit more distilling, with the claim that the product was of Puerto Rican 'manufacture'. The rebate has been split between Puerto Rico and the distillers involved, to the disadvantage of competitors.

-Another restriction on tax avoidance in the bill concerns cases where shareholders pay no tax on a portion of dividends in situations where the current earnings and profits rules understate economic income. This is addressed by modifying the definition of earnings and profits used for determining whether dividends are tax-free, so that the definition will more closely reflect a corporation's economic income rather than taxable income.

-A major provision of the bill limits tax benefits available for property leased to or otherwise used by tax-exempt entities, whether units of government or foreign entities. There is little justification for letting tax benefits flow to entities that by definition are tax-free, while the rest of the taxpayers pick up the tab.

- o Earned Income Credit.--The bill provides the first increase in the earned income tax credit (EITC) since 1978. The EITC is one of the few refundable credits in the tax code and is designed to help the lowest income taxpayers who are trying to make it on their own without government assistance, but who are faced with significant social security and income tax burdens as a result of being in the work force.

The bill increases the EITC percentage from 10% to 10.5%, and raises the phase-out level of the credit from \$10,000 to \$11,000. This should help working families "at the margin", including working women who are heads of households.

- o Targeted Jobs Tax Credit.--The bill extends the targeted jobs tax credit (TJTC) for 3 years, through 1987. The TJTC is available to employers of individuals from groups found to be particularly disadvantaged in the work force: handicapped participating in vocational rehabilitation, economically disadvantaged youth, economically disadvantaged Vietnam veterans, SSI recipients, general assistance recipients, economically disadvantaged cooperative education students and ex-convicts, AFDC recipients, and disadvantaged youth in summer employment. Currently 435,000 individuals are working under the TJTC program, and this 3-year extension should broaden employment opportunities for the disadvantaged in our society.
- o Spousal IRA.--The bill would phase in rules to give nonworking spouses the same IRA privileges as working spouses have. As a matter of basic equity, the Finance Committee believed that spouses with no earned income should have the same advantage in saving for retirement as spouses with earned income, because they have the same need. Over a 7-year period, the bill would phase in a full spousal IRA deduction of \$2,000 per year.
- o Mortgage Credit Certificates.--The mortgage revenue bond (MCC) program was designed to aid homebuyers at the lower end of the income scale seeking to buy a home. The bill does extend MRBs, but the committee was concerned that the program has not been properly targeted to those most in need. To remedy this problem, the bill authorizes State and local governments to offer mortgage credit certificates (MCCs) in lieu of bond financing. The entire benefit would go to

first-time homebuyers, and would be phased out for taxpayers above median income. The same Federal resources can in this way be targeted more effectively to those who most need assistance.

- o Enterprise zones.--While economic recovery is proceeding at a fast pace, the committee recognized that some areas are always left behind, where development and jobs can't seem to get a foothold. To help these distressed areas help themselves, the bill authorizes 75 "enterprise zones" over 3 years, to be chosen based on degree of distress and State and local contributions to development. These areas will get Federal tax and regulatory relief, including new jobs and investment credits, capital gains relief and greater availability of IDB financing. The goal is to avoid the federally directed subsidy programs of the past, and give communities the tools to develop the inner cities and depressed rural areas in cooperation with the private sector.
- o Architectural barriers to the handicapped.--The committee was concerned with the need to ensure that citizens who have a physical disability have an equal chance to participate in the workforce and in society. Accordingly, the bill reinstates the deduction for removing architectural and transportation barriers to the handicapped for 2 years, and increases the deduction from \$25,000 to \$35,000. Examples are providing access ramps, special entrances and exits, elevators, or special transportation services.
- o Charitable use of autos.--To help those who give their time and energy in voluntary public service, the bill increases the amount that taxpayers can deduct for mileage costs for using their car in charitable service. The deduction would rise from 9 cents to 12 cents per mile.