BOB DOLE
KANSAS

United States Senate
OFFICE OF THE MAJORITY LEADER
WASHINGTON, DC 20510

Betty

December 16, 1985

M E M O R A N D U M

TO: SENATOR DOLE

FROM: STAFF

SUBJECT: YOUR TALK TO THE ASSOCIATION OF ADVANCED LIFE UNDERWRITERS AT THE J. W. MARRIOTT, SALON F AT 12:00 P.M. TODAY

Attached are materials for your luncheon talk to the Association of Advanced Life Underwriters. Included are talking points on insurance taxation, tax reform, and the deficit.

Att.

ASSOCIATION FOR ADVANCED LIFE UNDERWRITERS

Tax Reform Issues

- On individual policyholder issues, the Ways and Means Committee refused to accept any of the principal changes proposed by the President.

- The Ways and Means Committee agreed with the AALU that inside buildup on life insurance should remain untaxed. They also generally left unchanged inside buildup on deferred annuities, with some exceptions.

- On the fringe benefit side, the Ways and Means Committee left unchanged the tax treatment of group term life insurance and group health insurance, although I understand that was a closer issue than inside buildup.

- While Ways and Means did not repeal section 401(k), as suggested by the President, but they did reduce the cap on elective deferrals from $30,000 to $7,000.

- In addition, Ways and Means decided to provide a "first-dollar" IRA offset. Therefore, rather than affecting only a small number of employees, it will impact nearly everyone who participates in a 401(k) plan. This really does not make much sense from a policy point of view. It seems to be driven by a desire for more revenues, rather than anything else.

- Assuming the Ways and Means bill gets to the Senate, we will have to look more carefully at the 401(k) issue as well as the changes in the annual contribution limits for qualified pension and profit-sharing plans.

- Setting the maximum amount that can be set aside in a tax-favored pension plan is an arbitrary thing, and it is hard to argue that the Ways and Means proposal to reduce the maximum annual retirement benefit from $90,000 to $77,000 is obviously inadequate. However, it may be argued that we need to allow these limits to remain untouched and allow indexing to go into effect again so that people can adequately plan for their retirement.

- In addition, Ways and Means had made a number of more technical pension changes which we will want to review carefully.

Senate Action

- Senator Packwood seems not be all that interested in starting with the Ways and Means bill. He believes, as I do, that while our flexibility may be more limited than we would prefer, we can do better in the Senate than the House did. I am not sure what precisely will be marked up, but we should be able to do better on items like tax rates and the personal exemption.

- Assuming the Ways and Means bill passes the House, it will probably take until July or August before a bill can work its way through the Senate, conference, and be sent to the President.

- Actual markup in the Finance Committee will not begin until after the Lincoln Birthday break which ends February 17th.

- Senator Packwood probably will try to get a bill out of Committee by the Easter break which is tentatively scheduled to begin March 27th.

- There will need to be some time for drafting before we can schedule the measure for Senate floor action. Thus, although it is possible that we could begin floor action after the Easter break, it may have to be delayed a little. May is a short month because of Senator Packwood's primary election on May 20th and the Memorial Day break.

- To be realistic, we probably will have to spend most of June on the Senate floor, leaving the time between the 4th of July and the August recess for conference and final passage.

THE DEFICIT AND THE AVERAGE AMERICAN

- Unless we enact a massive deficit reduction measure, 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.

- Most economists believe that enactment of the deficit reduction package as large as the Senate offer 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: creative to what they otherwise would be.

- With a 2% drop in interest rates, the monthly payment on a median priced home ($80,000) will 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.

- This year alone, 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.

- I don't believe we can let this budget negotiation fail. If we don't act now on major deficit reduction, the American people will pay the price. By 1989, interest on the debt alone would take up half of all individual income tax payments. The interest cost would be $250 billion or $1,100 for each American.

- If we can get something like this package 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.

ESCALATING DEFICIT

The main threat to continued economic expansion is run-away Federal spending.

- Since 1940, the Federal Government has run deficits in 37 out of the last 45 years. Since 1960, we've run deficits in 24 out of 25 years.
- In 1985, the gross Federal debt will total $1,841 trillion, an increase of 533% over 1960, 238% over 1975, and 101% over 1980. The total debt in 1985 now stands at 48% of our GNP.
- With no changes in Federal spending policy, CBO projects that Federal outlays will rise from $950 billion in 1985 to $1,378 trillion in 1990--an increase of $428 billion in five years.
- If no changes are made, the budget deficit will increase from $214 billion in FY 85 to $300 billion in 1990 and the National debt will increase to $2,786.

INTEREST ON THE DEBT

This 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 will 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.

Reagan's Tax Reform

- The President has proposed a striking and historic revision of the income tax laws. His plan would make the system both simpler and fairer.

- The present 14 brackets would be replaced by just three: 15%, 25%, and 35%. The maximum corporate rate would drop to 33% (with graduated rates for small business).

- The plan as a whole would shift the tax burden away from working people and toward businesses that have a lot of income but haven't paid their share of tax. Total taxes paid by individuals would drop 7 percent, while corporate tax payments would rise about 9 percent.

- Distributional Offset. Under the Reagan plan, families with incomes of $10,000 or less would get a 35.5% tax cut; $10,000 to $15,000, a 22.8% tax cut; $15,000 to $20,000, a 13.5% tax cut; $20,000 to $30,000, an 8.7% tax cut; $30,000 to $50,000, a 6.6% tax cut; $50,000 to $100,000, a 4.2% tax cut; $100,000 to $200,000, a 4.1% tax cut; and $200,000 or more, a 10.7% tax cut (the larger-than-average break for the top income group results from the lower top rate of 35% and the lower top capital gain tax rate of 17.5%).

- Return Free System. Under the Reagan plan, only 33% of taxpayers are expected to itemize. In addition, more than half of all taxpayers would be able to get their tax bill or refund without filing a return (if they so choose).

- Protection for Low Income. The plan would remove from the tax rolls virtually all families, married couples, single heads of households, and older Americans at or below the poverty line. This would result from the combination of increasing the personal exemption, zero bracket, earned income credit, and the new consolidated credit for the blind, elderly, and disabled.

- Indexing Protection. The plan retains the indexing protection for rate brackets, the personal exemption, and the zero bracket which we pioneered in 1981. Most plans that claim to do more for middle incomes (like Bradley-Gephardt) do not protect taxpayers against inflation and would do less for them in the long run. President Reagan also expands the indexing concept to the earned income credit, protecting the working poor, to depreciation and to capital gains (in 1991).

- Business and Growth. President Reagan proposes a system of business taxation that is more neutral and will reduce tax-motivated distortions that skew economic decisions. Repealing the ITC and revising depreciation schedules mean greater neutrality among different investment categories. Other changes that will limit economic distortions include limiting real estate tax breaks to the amount at risk, and tightening the minimum tax with regard to oil and gas tax breaks (intangible drilling costs).

- Issues to Watch. Congress is giving the President's plan a very close look, and no doubt many Members have particular changes they want to propose. In particular, there will be focus on:

  - Distribution of Tax Burden. Some are concerned about the break for the top income class--but to address that would require changing the rate structure on the capital gains exclusion, both very sensitive issues. Secretary Baker's proposals to drop inventory indexing, eliminate 401(k)s, and restore the child care credit will help make the case this is a revenue-neutral plan.

  - Neutrality/Investment. Any perceived deviation from "neutral" tax treatment for different industries will bring demands for change from other industries. In addition, those industries most heavily subsidized by the current code--like those which benefit from the ITC because they are capital-intensive--will want to minimize the effect of the plan.

  - State and Local Taxes. Secretary Baker has said that eliminating the deduction for State and local taxes is a sort of "acid test" for serious tax reform. This is a $40 billion item over the projected phase-in period, and that amount would be difficult to make up. If high-tax States can fight off this change--even in the context of much lower tax rates and other benefits that ease the tax take on their citizens--progress may be difficult. A compromise that doesn't lose much revenue may be necessary.

Tax Reform Talking Points

- Conceptually, the President's proposal and the Ways and Means Committee bill are quite similar--they both shift more of the tax burden to corporations and reduce the tax burden on individuals.

- 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.

- The President's plan repealed many of the complicated provisions of current law and thus did a better job of simplification than the Ways and Means Committee effort, which modified, but left in place, many of the complex incentives.

- If fairness means having taxpayers with equal incomes pay similar amounts of tax, the Ways and Means Committee did worse than the President. Fringe benefits and itemized deductions are the major causes of differing tax liabilities. Unlike the President's proposal, Ways and Means retained the State and local tax deduction, limited interest paid deductions less, and did nothing on fringe benefits.

- The Ways and Means Committee retained many of the politically popular big-ticket items. Unless we want to tackle those, the Senate will have limited flexibility in trying to enhance investment and savings incentives.

- I have personally long favored income tax reform and, as Chairman of the Senate Finance Committee, lead the fight over a number of years to plug unjustified tax loopholes.

- Nevertheless, I know that many of my Senate colleagues have no enthusiasm for the President's version of tax reform and even less for the Ways and Means bill, which they view as even more likely to have harmful economic effects. In the Senate, with its more open procedures, it is easier for a determined minority to block or slow down a bill they oppose.

- It is possible that the Senate might be able to fashion its version of a tax reform bill by June, but only with intensive effort by the President to push the bill and reshape it along the lines he favors.