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United States Senate

OFFICE OF THE MAJORITY LEADER
WASHINGTON, DC 20510

January 31, 1986

M E M O R A N D U M

TO: SENATOR DOLE

FROM: GEORGE PIELER

SUBJECT: TALK TO NEVADA TAX AND INDUSTRY COUNCIL, MONDAY,
FEBRUARY 3

Attached are materials for your talk to members of the Nevada Tax and Industry Council on Monday at 8:15 a.m. at the Watergate, covering the budget situation and tax reform.

In addition, attached is a page discussing issues the group suggested for discussion. The investment tax credit and capital gains, energy credits, and the impact of Gramm-Rudman on the dollar and on inflation.

NEVADA TAX AND INDUSTRY COUNCIL

MONDAY, FEBRUARY 3, 1986, 8:15 A.M.

Investment Credit/Capital Gains

- o The members of the Senate Finance Committee have made it clear that the House tax bill is unacceptable in its effect on capital formation, savings, and investment. President Reagan also has pledged to improve the Senate version of the bill in those area.
- o At the same time, revival of the investment credit is unlikely -- we're more likely to focus on improving the House's depreciation schedules. On capital gains, the President wants a top rate no higher than current-law rate of 20% (the House bill effectively raises the rate to 22%). I expect the Senate will be sympathetic to that goal, if it can be achieved consistent with the goal of revenue neutrality.

Energy Tax Credits

- o The House tax bill extends the residential and business solar energy credit for three years, while phasing down the rates and imposing new limitations. The business credit for geothermal energy would be extended and phased down over three years. The other credits, including the 60 cents a gallon credit for alcohol fuels, generally either are repealed or allowed to expire.
- o The Senate has generally been sympathetic to the credits for alternative energy sources, but of course those credits need to be reexamined in light of the changing market for energy, including the drop in oil prices and more efficient use of existing energy supplies. Whether the Senate can revive any of the credits depends, of course, on revenue considerations and on first meeting our top priorities: improving the climate for savings and investment.

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Gramm-Rudman, the Dollar, and Inflation

- o Gramm-Rudman should help us meet the commitment we made last September to our trading partners: to reduce the deficit as part of our effort to moderate the value of other dollar.
- o By the same token, the risk of inflation should be reduced if we bring down the deficit under Gramm-Rudman, because the pressure to pump up the money supply to keep interest rates down will ease considerably.

Gramm-Rudman: Challenge to the Established Fiscal Order

- o The first actions in response to the new Gramm-Rudman deficit control reform will be taken early in 1986. For those of you who missed it, late last year the Congress imposed a new fiscal straightjacket on itself. The new law sets firm deficit targets for each of the new five years, and mandates automatic across the board spending cuts if the deficit exceeds the target. The first round of automatic cuts under the proposal will take effect March 1 unless Congress comes up with a better way to meet the target.
- o In addition, President Reagan's budget for fiscal year 1987 is due to Congress by February 5. So we will have reconsideration of the 1986 budget proceeding simultaneously with our first shot at the 1987 budget.

That is a tall order, but is one we ought to be able to fill. Difficult as it seems, we should remember that the Gramm-Rudman law contains new procedures designed to make it easier to meet the deficit targets. We explicitly bring loan programs and other 'off-budget' items into the budget process; set a point of order against legislation from committees that have not met their budget savings allocation; and rule out of order legislation inconsistent with the deficit targets.

Possible Problems. We know there may be a rocky road ahead in implementing Gramm-Rudman. Congressmen Synar and others have filed suit claiming it is unconstitutional, and the Reagan Administration has some problems as well with the role of the Congress' General Accounting Office in mediating the deficit forecasts. The courts will have to guide us on all that. Even more important, what Congress can legislate, Congress can back out of. That's why we need a constitutional mandate for budgetary restraint, as well as a statutory one.

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- o So Gramm-Rudman hasn't made our options any easier: but if it works as planned, it will force us--and the President--to make some decisions and choose among the various deficit-reduction options. That means everyone's cherished spending programs will be put to the test of fiscal responsibility.

Spending the Key. Finally, let me emphasize that Gramm-Rudman is a device for reducing Federal spending. It is not a tax increase plan, or a subterfuge for one. If we fail on the spending front, we can look at other options. But the sooner we entertain any revenue options, you can bet the pressure for spending cuts will drop fast.

The Deficit and the Average American

- o Unless we follow a deficit reduction path like that mandated under Gramm-Rudman, 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. That is what the Gramm-Rudman-Hollings initiative is all about.
- o Most economists believe that enactment of deficit reduction measures that eliminate the deficit by the end of the decade 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: relative to what they otherwise would be.
 - With a 2% drop in interest rates, the monthly payment on a median priced home (\$80,000) would 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.
 - In 1985, 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.

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Interest on the Debt

The 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:

- o 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.
- o In 1985, interest on the national debt 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.
- o \$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.

But if we can adhere to the deficit-reduction goals we've set for ourselves, 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.

Tax Reform Talking Points

- o The President's tax plan and the House bill are similar in concept--they both shift more of the tax burden to corporations and reduce the tax burden on individuals. But the bills are very different in how they make the change.
- o 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.
- o Neither plan gets an A+ for the major objectives of tax reform--simplification and fairness, but the President's plan repealed many more of the overly complicated provisions of the tax code than the Ways and Means Committee effort. The House bill just modifies, but leaves in place, many complex tax rules.
- o The House bill falls far short of the President's on fairness grounds. Fringe benefits and itemized deductions are major causes of differing tax liabilities, and unlike the President's proposal, the House retained the State and local tax deduction, did less to limit interest-paid deductions, and did nothing on fringe benefits. This means that taxpayers with equal incomes can still have substantially different tax liabilities.
- o The House retained many of the politically popular big-ticket items like tax-free fringe benefits and the State and local tax deduction. Unless we want to tackle those, the Senate will have limited flexibility in trying to enhance investment and savings incentives.
- o I have personally long favored income tax reform and, as Chairman of the Senate Finance Committee, led the fight over a number of years to plug unjustified tax loopholes.
- o 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 House 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.

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- o 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.