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DOCUMENT NO. & TYPE	SUBJECT/TITLE	DATE	RESTRICTION
1. memo	Donald Regan to Martin Feldstein re 9/28 speech before the National Association of Business Economists, 1p [Item is still under review under the provisions of EO 13233]	9/26/83	
~~2. memo~~	~~Acting Commissioner of Internal Revenue to Regan re child care credit on Form 1040-A, 2p [Item is still under review under the provisions of EO 13233]~~	~~9/16/82~~	

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THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

September 26, 1983

MEMORANDUM FOR MARTIN FELDSTEIN
CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

SUBJECT: Your Speech of September 28th before the National Association of Business Economists

In accordance with our agreement with the President to exchange speeches, I'm glad you sent me a copy of your proposed remarks before the National Association of Business Economists on Wednesday, September 28th. I have read your speech and I must say I feel it violates the spirit if not the substance of what the President told us are his views and policies on the deficits, tax increase, and the recovery. I don't feel that the speech in its present form should be given. It is negative.

On behalf of the Administration, you assume full responsibility for budget deficits, downplay our efforts to restrain spending growth, and assert that the economic recovery will be aborted unless tax increases are enacted. Your remarks leave the impression we have sole responsibility for the deficits and that we must solve this problem immediately by increasing taxes.

You know I agree that deficits must be reduced, but in the current atmosphere I question the wisdom of devoting an entire speech to a discussion of deficits and their adverse impact on future economic activity without adequately referencing the many positive developments now taking place in the economy. As you know, recent economic statistics suggest that the recovery is well underway, sustainable and, in fact, has been stronger than all of our official predictions. It seems to me that these remarks could have come from one of the President's critics rather than from the Chairman of his Council of Economic Advisers.

Don

Donald T. Regan

cc: The President
James A. Baker, III
David R. Gergen

FOR RELEASE UPON DELIVERY
12:30 p.m.
September 28, 1983

BUDGET DEFICITS: TWELVE BASIC QUESTIONS AND ANSWERS

Remarks

By

Martin Feldstein, Chairman

Council of Economic Advisers

to the

National Association of Business Economists

Detroit, Michigan
September 28, 1983

Budget Deficits: Twelve Basic Questions and Answers

Martin Feldstein*

Thank you. I am very pleased to be with you today. I have many opportunities to speak in my present position, but I particularly welcome the chance to talk with a group in which I have so many friends and professional colleagues. I feel especially at home here since I am a member and Fellow of the NABE.

It is of course tempting to use this occasion to give you a general progress report on the economy's performance and on the achievement of the Administration's policy goals. But I'm sure most of you are quite familiar with the very favorable developments of the past half year: the spectacular pace of recovery in the second quarter, the decline in unemployment to 9.5 percent, and the continuation of a very low rate of inflation. You are also do doubt aware of the slowdown of production and demand that began in July and most of you probably share my view that, despite actual declines in several components of aggregate demand, there is currently no cause for concern. We can reasonably expect that demand will begin to expand again in the coming months and we can hope that the recovery is in the process of shifting to a more sustainable rate of economic growth, with real GNP rising 6 to 6.5 percent this year and probably between 4 and 5 percent from the final quarter of 1983 to the final quarter of 1984.

*Chairman, Council of Economic Advisers. These remarks will be presented as the luncheon address to the Annual meeting of the National Association of Business Economists, Detroit, Michigan, September 28, 1983.

Instead of discussing the general economic outlook, I will therefore focus my remarks on what I believe is the most important economic policy issue facing the country today: the budget deficits. I think that you probably all know my general views about budget deficits. In my first speech as CEA Chairman I warned of the dangers of the projected budget deficits and I haven't stopped sounding the warning since then. Indeed, long before I went to Washington, I was concerned about our nation's low rate of capital formation. Now, despite improvements in our tax law and regulatory environment, large budget deficits threaten to depress capital formation to even lower levels than in the past. And, in the nearer term, large budget deficits are producing a lopsided recovery that could cause the recovery to come to a premature end.

Today I want to be more specific about the nature of the budget deficit problem and about alternative remedies. I thought it would make it more interesting if we organized this as a question and answer session. But, since our time is very short, I decided that it would be best if I just imagined the questions that some of you would have asked. With that in mind, I wrote twelve questions that I hope will cover most of the things that you would have wanted to ask. So here's your first question:

1. <u>How big are the projected deficits?</u>

In a word, they are enormous. According to the Administration's most recent mid-year budget review, the so-called current services budget deficits would be about $200 billion in each fiscal year from 1984 through at least 1988. The current services budget assumes that domestic programs continue at the same level of real services, that current tax laws remain unchanged, and that the Administration's defense proposals are approved. Although it now looks like the actual deficit for the current fiscal year will be about $200 billion, by keeping the pressure on Congress to reduce future spending, next year's deficit may be about $20 billion lower. But the cumulative deficit over the next five years still could be more than $1000 billion, an amount greater than the total of all the deficits since the country began.

We've become so accustomed recently to hearing about $200 billion deficits that it's easy to forget how unprecedented a string of such large deficits would be. The 1982 deficit was $111 billion and it was far greater than anything previously experienced. Before that, the largest previous deficit was the $66 billion of 1976.

The shocking magnitude of the current deficit is not just a reflection of the rising price level. Even when all of the previous deficits are converted to 1982 dollars, the largest deficit since World War II was in 1976 when the deficit was equivalent to $105 billion in 1982 prices.

Similarly, when the budget deficits are expressed as percentages of GNP, there has been nothing since World War II that compares with those now in prospect. This year's deficit is 6.5 percent of GNP. The projected current services deficits then decline slowly to exactly 5.0 percent of GNP in 1987 and 4.2 percent in 1988. The largest previous postwar deficit share of GNP was the 4.0 percent in 1976. In short, these deficits would be something completely new for a peacetime economy.

To put this much government borrowing into perspective, it's useful to remember that gross private saving -- including the saving of businesses, households and pensions -- averaged only 16.5 percent of GNP in the years since 1950. Moreover, since most of this investment was required just to replace the capital stock that was wearing out, net private saving averaged only 7.2 percent of GNP. A budget deficit of five percent of GNP would therefore absorb about three-fourths of all net domestic savings, leaving less than two percent of GNP available to finance investment in housing and in plant and equipment. This would simply not be enough capital accumulation to keep up with the growth of the population, let alone to finance an improving stock of housing and an increasing stock of plant and equipment per worker.

Moreover, since net additions to the nation's stock of plant and equipment earn a real net rate of return of about 12 percent, a string of deficits that reduces the capital stock by $1000 billion would also cause a permanent reduction of about $120 billion a year in real national income. That works out to be an income reduction equal to about $2000 a year for a family of four.

And now for your second question.

2. <u>Couldn't the budget deficits be much smaller if economic growth exceeds the Administration forecast?</u>

Yes, it's true that faster growth means more tax revenue and less spending on cyclically sensitive programs like unemployment insurance. But the effect is rather small. Each additional one percent increase in the level of real GNP reduces the budget deficit by between $10 billion and $15 billion. Thus if real growth exceeded our forecast by a full percentage point in 1984 and then again in 1985 and 1986, the implied budget deficit in 1987 would be between $175 billion and $200 billion instead of the currently forecast deficit of about $225 billion. In short, even the quite substantial uncertainty that always surrounds economic forecasts cannot alter or obscure the enormity of the projected deficits.

I might just add that our current forecast must be judged to be a relatively optimistic one. The 4.3 percent real growth projected between 1983 and 1988 is slightly greater than the growth forecast by standard private forecasters like Data Resources (a 3.6 percent annual rate) or implied by the Congressional Budget Office forecast which stops in 1986 at 3.5 percent after growth at 4.1 percent from 1983 to 1986.

Even more important is the assumption in our budget projection that market interest rates will decline sharply over the next few years. We predict, for example, that the Treasury bill rate will decline to 6.1 percent by 1988 and that longer-term debt will decline by an even larger amount. If interest rates fail to fall from their current level, the extra interest cost on the 1988 public debt of more than $2 trillion would be about $75 billion. The resulting 1988 deficit would then be close to $300 billion.

3. <u>How much of this budget deficit is "structural" and how much is "cyclical"?</u>

Budget deficits are natural when the economy is operating below capacity. Tax revenue is depressed and cyclically related spending is high. This "cyclical" component of the 1983 deficit amounts to about $85 billion; if the economy were currently operating at a 6.5 percent unemployment rate, a figure that we use as an estimate of the minimum sustainable unemployment rate with existing labor market institutions, the remaining "structural" budget deficit for 1983 would be about $115 billion.

What's unusual about the current outlook is not just that the structural deficit is very large but that it is projected to increase as rapidly as the cyclical deficit declines. Since we forecast a fiscal year 1988 unemployment rate of 6.4 percent, the entire projected deficit of about $200 billion in that year would be structural.

This brings me to the fourth question, and one that might come from someone who thought all the concern about deficits was exaggerated and unnecessary.

4. Why so much fuss about deficits? Isn't the real problem government spending? And aren't deficits just a postponement of paying for government spending?

While it's true that deficits can be thought of as the result of postponing payment for government services, it's definitely not correct to say (as some do) that only government spending matters. Whether that spending is paid for by taxes or borrowing can have a profound effect on the economy.

If spending is financed by taxes, the primary effect is to reduce consumer spending. (Of course, the precise effect depends on the type of tax, but what I have said is certainly true about an across the board increase in personal income tax rates.) In contrast, if the government spending is financed by borrowing, the primary effect will be to reduce investment and net exports.

Moreover, the accumulation of debt that would result from the projected budget deficits would mean substantially higher taxes in the future just to pay those interest costs. A $1200 billion cumulative deficit between 1983 and 1988 would mean extra interest costs by 1988 of about $100 billion. To finance these interest costs would require an increase in tax revenue equivalent to a 21 percent surcharge on the personal income tax. And the $100 billion of extra interest costs would be a permanent burden on the American economy that would have to be financed by higher taxes year after year.

5. Must there be the "crowding out" that we hear so much about?

In other words, must an increase in the government deficit cause a reduction in investment or net exports or both? The answer in practice is "definitely yes".

There are, of course, theoretical models in which crowding out need not occur. If an increase in the budget deficit induced individuals to raise their saving by an equal amount, there would be no crowding out of investment or net exports. There is, however, no indication that such an increase in saving has taken place or that it would ever be likely to take place. Indeed, personal saving as a fraction of disposable income and total net private saving as a percentage of GNP have both declined significantly in the past two years.

In the simplest textbook Keynesian models, there is no crowding out because an increase in the deficit causes such a large rise in real national income that the saving out of this extra income is sufficient to finance the entire increased deficit. But even the textbooks are quick to point out the many reasons why this would not occur in practice and therefore why an increased deficit must be accompanied by some crowding out of investment and net exports.

Looking at the very simple Keynesian extreme, how much of a rise in real GNP would be needed to generate enough extra savings to avoid crowding out? Even if 20 cents out of every extra dollar of income were saved -- and that would be about three times the historic ratio of net savings to GNP -- the rise in income would have to be five times as great as the rise in the deficit. By this calculation, the increase in the deficit from the roughly $50 billion annual rate in the late 1970's to a $200 billion rate would cause no crowding out only if GNP rose some $750 billion because of the deficit, that is, only if without the increased deficit GNP would currently be about one-fourth lower than it actually is. I think there can be no doubt about the implausibility of such an induced increase in income and therefore no doubt that crowding out must occur.

It is clear, moreover, that if, with the help of monetary policy, the economy remains on a desired path of real economic growth and inflation, any increase in the budget deficit must cause a dollar-for-dollar crowding out. If government spending rises by a dollar, private spending must decline by a dollar. If government spending remains unchanged and a tax cut raises consumer spending by a dollar, then the combination of investment and net exports must fall by a dollar.

6. <u>But does that mean that crowding out is happening now and that it is not just a problem for the future?</u>

Yes, exactly. How could it be otherwise? The deficit increased from 2.3 percent of GNP in 1980 to about 6.5 percent of GNP in 1983 while the total net saving of the private sector and of state and local governments has continued to be the same share of GNP.

Since there's been a good deal of confusion about this question, let me look at the evidence in more detail. Just where is the crowding out taking place?

The first obvious place is in the reduced level of net exports. The budget deficit has raised the real interest rate, causing the dollar to appreciate sharply and inducing a decline of exports and a rise of imports. In 1980, the merchandise trade deficit -- the excess of our imports over our exports -- was $26 billion. This year we expect it to be about $40 billion larger and next year as much as $70 billion larger than the 1980 level. The exports that are lost and the imports that replace goods that would otherwise have been made in this country are both very tangible examples of crowding out.

The traditional form of crowding out is reduced investment and the share of GNP devoted to investment has indeed declined sharply. There are of course many factors that influence investment and those who have been skeptical about the extent of the current crowding out sometimes point to the low level of capacity utilization as an explanation of the reduced level of investment. It's useful therefore to look first at investment in housing -- both owner occupied and commercial -- in order to avoid the ambiguity caused by low capacity utilization.

Last year, gross residential investment declined to a level which, after adjustment for inflation, had not been seen since 1967. The decline in net residential investment was even more dramatic, driving real net residential investment far below the lowest level that had previously been experienced at any time in the postwar period. Even with the recent recovery in housing activity, there was only one year between 1960 and 1980 in which net residential investment was lower than it was in the first half of 1983. When viewed as percentages of GNP, net residential investment in 1981, in 1982 and in the first half of this year are all below the lowest previous postwar level.

Business investment in plant and equipment -- that is, net fixed nonresidential investment -- also declined last year to a level that represented the lowest share of GNP in nearly a quarter of a century. With the further decline in non-residential investment that has occurred this year, the nonresidential investment share of GNP has reached the lowest level in the postwar period. It is, of course, not clear how much of this decline was caused by the high cost of capital but there seems little doubt that a lower level of real interest rates would have provided an increased incentive for investment in modernization as well as in capacity expansion.

Why would anyone believe that there is no crowding out of investment at the present? Although I've heard no one suggest that the deficit has not depressed net exports or housing investment, a number of arguments have been offered in support of the proposition that there has been no crowding out of business investment. Some have concluded, for example, that businesses are not being deprived of funds because business loan demand at the banks is low or because businesses are investing in Treasury securities. Of course, such evidence implies nothing of the kind. With real interest rates very high, it is not surprising that businesses don't want to borrow and prefer to invest in Treasury securities rather than real plant and equipment. Indeed, that is the very essence of direct crowding out.

It is sometimes argued that businesses now have no need to borrow because they have all the funds they need from retained earnings and from issuing new equity securities. But while it's true that cash flow has improved and that firms are responding to the stock market rise by issuing some new equity, the primary reason for the high ratio of equity finance to investment is that the investment rate itself is relatively low at a time when the favorable 1981 tax changes in depreciation rules might have been expected to produce a major increase in investment.

7. Does crowding out depend on the assumption that budget deficits raise interest rates? And isn't there some doubt about that?

I'm glad you asked that. The conclusion that budget deficits crowd out investment doesn't depend on the relation between deficits and interest rates. As I've explained earlier in my remarks today, crowding out is an inevitable consequence of the fact that an increase in the deficit doesn't cause an equal increase in savings. The market process that causes private investors to make the necessary reduction in investments in housing and in plant and equipment is of course a rise in their cost of funds or, roughly speaking, a rise in the real rate of interest.

Note that I said the <u>real</u> rate of interest. Some of the confusion about the relation between the budget deficit and the interest rate may be due to focusing on the nominal market rate of interest. Nominal rates of interest have fallen sharply in the past two years in response to the fall in expected inflation but, at the same time, the real interest rate has increased. Thus in 1981, when the yield on prime 6-month commercial paper was 12.3 percent, the GNP price deflator was rising at the rate of 9.4 percent, implying a real interest rate of 2.9 percent. In the first half of this year, the commercial paper rate was down to 8.5 percent but the GNP deflator rose at a rate of only 4.5 percent, implying that the real interest rate had increased to 4.0 percent, a rise of 1.1 percent.

Even focusing on the real interest rate is a simplification. What matters for investment decisions is not the real interest rate but the difference between the real net-of-tax cost of funds and the real net-of-tax rate of return on investments. Because our tax laws are far from inflation neutral, the incentive to invest depends on the inflation rate as well as on the real rate of interest. This is not the place to discuss that complex subject on which, as some of you know, I have written at excruciating length in the professional economic literature.[1] But I do want to emphasize that the deficit can raise the relevant cost of capital even if the real interest rate is unchanged.

A rise in the real interest rate, such as we are experiencing now, is however likely to indicate an increase in the relevant cost of investment funds, even if it is not a necessary part of the process of crowding out. The important point is that the conclusion that deficits crowd out private investment or net exports is fundamental and that the effect on real interest rates -- or whatever it is that we call the cost of capital -- is only of secondary interest.

8. <u>But can't an easier monetary policy reduce the real interest rate and eliminate the crowding out?</u>

The answer in short is, "No." There is no way for monetary policy to offset the crowding out caused by a series of $200 billion deficits. The total increase in the Federal Reserve's holding of government securities in a year is likely to be less than $15 billion and any substantial increase in this total would cause an inflationary surge in the money supply. So the only thing that the Fed could really do to reduce crowding out would be to pursue a monetary policy designed to increase real income and therefore savings. But even if such a policy could add as much as three percentage points

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[1]A set of my scientific papers on this subject are collected and discussed in M. Feldstein, <u>Inflation, Tax Rules and Capital Formation</u>, Chicago: Chicago University Press, 1983.

to the real growth rate for a single year, the likely addition to total private savings would be less than $25 billion. Moreover, any such increase in the real growth rate that was achieved in this way would be only temporary and would be accompanied by a rise in the rate of inflation.

As long as the Federal Reserve pursues a sound monetary policy -- one that is consistent with sustained growth and a gradually declining rate of inflation -- large budget deficits mean that the real rate of interest is likely to remain high. And while a sudden expansion of the money stock might temporarily reduce the real interest rate, it would soon also raise the inflation rate and the market rate of interest.

The notion that an easier monetary policy should be pursued in order to counteract the high interest rates that result from the large current and prospective budget deficits is particularly pernicious because, if it were seriously pursued, it could rapidly lead to a reversal of all of the gains that have been made in reducing the rate of inflation.

9. <u>Can deficits actually reduce aggregate economic activity</u>?

The principal adverse effect of a long string of large budget deficits is to reduce capital formation and therefore to lower the growth of real income. Moreover, even in the nearer term, large budget deficits create a lopsided recovery in which the key industries involved in capital formation and in international trade do not participate fully in the economic recovery.

But although deficits reduce the demand for investment goods and for net exports, this certainly does not mean that deficits reduce total demand and economic activity since the deficits also mean more demand for either government spending or consumer spending or both. The idea that deficits can reduce total demand therefore seems to turn the traditional textbook analysis of deficits on its head. After all, the traditional textbook Keynesian view is that a deficit raises real GNP, which in turn raises the real interest rate, causing a reduction in investment and net exports. The net effect is nevertheless to have a higher level of economic activity than would prevail with a smaller deficit.

There are, however, a growing number of economists and other observers who believe that the projected deficits will actually reduce total activity in 1984 or 1985. Although there is no unambiguous answer on this issue, there are two quite separate reasons for thinking that they might be correct.

First, the lopsided recovery that results from contracting the investment goods industries and those industries engaged in international competition is likely to be inherently more fragile than a balanced recovery. The traditional analysis may be seriously misleading in assuming that the distribution of output among firms is irrelevant. In reality, two firms operating at 70 percent of capacity are likely to behave very differently than the sum of two firms in which one is operating at 50 percent of capacity and the other at 90 percent of capacity. The 50 percent of capacity firm is likely to close plants or otherwise lay-off workers permanently in a way that is not immediately offset by the behavior of the 90 percent operation rate firm. Moreover, the imbalance itself is likely to weaken business confidence, thereby reducing business investment.

Second, even if the lopsided nature of the recovery were not a problem and deficits did contribute evenhandedly to concurrent economic activity, the anticipation of future deficits may depress current economic activity. More specifically, the expectation of future deficits raises expected future interest rates (or the future cost of capital) and therefore the current long-term interest rate. This discourages current long-lived investment and therefore reduces current aggregate demand. Note that I am not saying that a dollar of current deficit crowds out other demand by more than one dollar. Rather my point is that the anticipation of future deficits may reduce current investment spending on net exports without any offsetting current positive impact.

The possible effect of anticipated future deficits implies that a combination of spending reductions and a prospective future tax increase, like the Administration's multi-year budget and standby tax plan, can reduce the risk that the present recovery will come to a premature end. By indicating that the deficits in fiscal year 1986 and beyond would be sharply reduced, enactment of those budget proposals would reduce long-term interest rates immediately. Since investment responds to interest rate changes only after a delay, it would be sometime next year before the volume of investment increased. The same delay would be true of the favorable effect on net exports.

But what, you might ask, about the households who might have to pay the higher future "standby" tax? Won't they feel poorer and reduce their consumption now, thereby depressing aggregate demand? I think not. Those households that are so farsighted that they take their future tax liabilities into account in deciding their current consumption no doubt already recognize that the current deficits represent a postponement of their tax liability so that an explicit enactment of a future tax increase should have little or no effect on their consumption. Moreover, to the extent that consumers recognize that the commitment to reduce future deficits will help to maintain a healthy recovery, their own income expectations will rise, encouraging a higher level of current consumption. Most consumers, however, are either less farsighted or simply choose to spend virtually all of their disposable income when they receive it; in either case, they will respond to a future tax increase only when it occurs.

My own view is that the lopsided character of the recovery and the anticipation of large future deficits are both very serious problems that, unless corrected, could well bring the present recovery to a premature end. That's not a prediction but a confirmation of the risks involved if the large deficits persist.

10. <u>What then should be done?</u>

The key is for Congress to act this fall to assure financial markets and other investors that the deficit will be declining sharply in the years ahead. Earlier this year, the President submitted a budget that would do just that. By the 1987-88 fiscal year, the Administration's budget would eliminate three-fifths of the projected deficit, reducing the projected deficit to 1.6 percent of GNP.

Our budget calls for a balanced mix of spending cuts and additional revenue; over the next five years, each of these would make an approximately equal contribution to reducing the projected deficit. The share of GNP devoted to domestic spending by the federal government has nearly doubled since 1960, rising from 8 percent of GNP to 15 percent. Shrinking that share is necessary if we are to avoid perpetual deficits or unacceptable tax increases.

Eliminating the budget deficit would also require additional tax revenue. Ideally, the extra revenue will be forthcoming without a rise in tax rates because economic growth substantially exceeds our forecast. But if this does not occur, the President's budget calls for an increase in tax rates that begins in late 1985.

The Administration's combination of policies would reduce the deficit gradually during the next two years and then much more sharply in the fiscal year that begins in October 1985. This has the advantage of cutting anticipated future deficits without the deflationary risk that would be involved in a sharp cut in demand in 1983 or 1984. It would reassure investors that deficits will be shrinking while still allowing the needed time for investment and exports to expand to absorb the resources released by the decline in the deficit.

11. Couldn't the deficit be cut by reducing defense outlays instead of cutting domestic programs and raising taxes?

Of course a dollar is a dollar. Reducing defense spending by a dollar shrinks the budget deficit by as much as an extra dollar of tax revenue or a one dollar reduction in domestic outlays.

But cutting the growth of the defense budget could not in itself save enough dollars to have a major impact on the total budget deficit. This year the defense budget will absorb 6.7 percent of GNP. The Administration's budget projects a growth in defense outlays to 7.7 percent of GNP in fiscal year 1988. Even if defense spending were held to the current share of GNP, that is, even if the growth of defense outlays was limited to only slightly more than four percent a year, the reduction in defense spending would equal only one-half of one percent of GNP by 1985 and only one percent of GNP by fiscal year 1988. The critics of defense spending in Congress and elsewhere are generally calling for reductions in the growth of defense outlays that are smaller than this and that would permit some growth in the defense share of GNP. It is clear that a budget deficit that exceeds four percent of GNP cannot be eliminated by defense cuts of less than one percent of GNP.

I don't know enough about defense to know whether the proposed 7.7 percent of GNP in fiscal year 1988 is too much, too little, or just right. But I do know that it is a smaller share of GNP than our nation spent on defense in 1960 and in 1970 when our budget was essentially in balance and that our nation can afford to spend that much again without causing a budget deficit.

12. Can Congress wait until 1985, as some have suggested, before enacting legislation to put deficits on a sharply declining course?

I think that would be a very risky policy. Although a sharp reduction in the deficit in 1983 or 1984 would be unwise, it is important to reassure investors and financial market participants now that our deficit will be falling by 1985. Legislation to reduce the future spending share of GNP and an explicit prospective tax increase could cause an immediate fall in real interest rates which would pave the way for more investment and exports to absorb the resources released by the lower deficit.

The danger in waiting until 1985 is that the economy cannot adjust to an unanticipated decline in demand caused by a sharp reduction in government spending or increase in taxes. The expansionary effects that the deficit reduction would have on interest sensitive investment and export activity would occur only with a lag while the contractionary effect of reduced government outlays or increased taxes would be immediate. If there is not a clear commitment now to start a major reduction of deficits in 1985, the most that would be prudent in 1985 might be the enactment of spending cuts and tax increases that would come into effect in 1987. The result of these delays would be an accumulation of billions and billions of dollars of additional national debt, a reduction in the nation's capital stock, and a recovery that is more lopsided and less healthy than it should be.

The key to appropriate fiscal policy is to recognize that there is a substantial lag between the time when a reduction in the budget deficit is enacted and the time when investment activity and net exports increase in response. That is why Congress cannot enjoy the political luxury of waiting until 1985 to enact the type of deficit reduction program that the Administration proposed.

Concluding Comment

That brings our question and answer period to an end. I hope that I have succeeded in answering the questions that you would like to have asked and in convincing you that dealing with the prospective budget deficits is now the most urgent task for economic policy.

Copy for Jim Cicconi
Office of James Baker
White House

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

Treasury memo

Dear Mr. Kelley:

By letters of November 4 and December 10, 1982, you have asked the Treasury Department to consider revising the regulations under Code section 6033 which define the term "integrated auxiliary of a church" for purposes of the exception from the information return filing requirements generally applicable to tax exempt organizations. The regulations (which were proposed and made final in 1976) provide that the determination of whether or not an organization is an integrated auxiliary of a church depends upon whether its principal activity is exclusively religious. An organization's principal activity will not be considered to be exclusively religious if that activity is educational, literary, charitable, or of another nature (other than religious) that would serve as a basis for exemption under section 501(c)(3).

In the memorandum attached to your letter of November 4 you object to the regulatory requirements that an "integrated auxiliary" have an exclusively religious principal activity and be separately incorporated. It is your view that the existing regulations are constitutionally defective. You specifically propose an amendment to these regulations which would redefine an "integrated auxiliary of a church" to include any organization

> "whose principal activity is integrated with the religious purpose of the church, convention or association of churches with which it is affiliated."

As revised, the regulation you propose would also "eliminate a narrow sacerdotal definition of religion and 'church'; [and] eliminate specious formalistic tests based on whether a church entity is or is not separately incorporated."

In response to your letter, we have reexamined the requirement that an "integrated auxiliary" have an exclusively religious principal activity. We believe that the position taken in the existing Treasury regulations correctly interprets Congress's intentions in modifying section 6033 in 1969. Prior to its amendment, section 6033 exempted from the filing requirement any "religious organization defined in section 501(c)(3)." When this exception was amended to apply specifically to "churches, their integrated auxiliaries, and conventions and associations of churches," Congress added the reference to "integrated auxiliaries" in reliance upon then-current Treasury regulations which defined the terms "church or convention or association of churches" to include a religious order or religious organization

> "if such order or organization (a) is an integral part of a church and (b) is engaged in carrying out the functions of a church.... A religious order or organization shall be considered to be engaged in carrying out the functions of a church if its duties include the ministration of sacerdotal functions and the conduct of religious worship. If a religious order or organization is not authorized to carry out the functions of a church ... then it is subject to the [unrelated business income] tax imposed by section 511.... (Reg. §1.511-2(a)(3)(ii)).

In explaining the codification of this "integral part"/"integrated auxiliary" concept, Congress specifically stated in the Conference report accompanying the 1969 Act that the new exemption applies to:

> any religious order with respect to its exclusively religious activities (but not including any educational, charitable, or other exempt activities which would serve as basis of exemption under section 501(c)(3) if an organization which is not a religious organization is required to report with respect to such activities). (H. Rep. 91-782, 91st Cong., 1st Sess., p. 286.)

The regulations under section 6033 comply with this clear statement of Congressional intent.

Your letter also requested us to reexamine the regulatory requirement that an integrated auxiliary be "controlled by or associated with a church or with a convention or association of churches." (Reg. §1.6033-2(g)(5)(i) and (iii)). In defining "associated with," the regulations further state that "an organization is associated with a church or a convention or association of churches if it shares common religious bonds and convictions with that church or convention or association of churches." (Reg. §1.6033-2(g)(5)(iii)). Here again the "separate organization" and "church association" concepts are based upon the above-cited Conference report explanation that the exemption should not apply to any organizations other than section 501(c)(3) organizations whose principal activities are exclusively religious.

church-affiliated organizations other than those described in section 6033(a)(1)(A) in any case where he determines that such filing is not necessary to the efficient administration of the internal revenue laws. Such discretionary exemptions have been granted both to educational organizations below the college level which are affiliated with a church or operated by a religious order (Reg. §1.6033-2(g)(1)(vii)), and to organizations which have gross receipts normally not in excess of $25,000 (IRS News Release 82-71, June 1, 1982). Thus, existing law provides adequate procedures for providing exceptions from the filing requirements where the burdens of filing and processing annual information returns outweigh the administrative benefits served by the returns.

You should be assured, in conclusion, that the Treasury's support of the existing statute and regulations relating to returns of exempt organizations and the concomitant procedures for granting discretionary exemptions is in no way intended to suggest that activities other than exclusively religious ones are improper for church organizations such as those represented by your Coalition. However, we believe that the existing information reporting requirements imposed upon separately organized entities which carry on charitable activities of a non-religious nature are needed in the administration of the tax laws applicable to tax-exempt organizations.

Sincerely,

Chapoton

John E. Chapoton
Assistant Secretary
(Tax Policy)

Mr. Dean M. Kelley
Secretary
Coalition on Internal Revenue
Definition of Religious Bodies
475 Riverside Drive
New York, New York 10115

CC: Mr. C. Boyden Gray

f Treas memos

9/16 cc: ED

Date: September 16, 1982

MEMORANDUM FOR: SECRETARY REGAN

From: Acting Commissioner of ~~Internal Revenue~~ [signature] for Jim Owens

Subject: Child Care Credit on Form 1040-A

Here are the reasons why we would advise against including the child care credit on Form 1040-A this year:

1. Less than a million current Form 1040 filers will be able to switch over to Form 1040-A to claim the child care credit. We therefore question whether it is advisable to complicate Form 1040-A for its present filing population of 37 million taxpayers by adding the child care credit. This would be the first time that an attachment (Form 2441, the child care credit form) would be filed with Form 1040-A.

2. If our new Form 1040-EZ is as successful as we think it will be, we will restudy form 1040-A for 1983 with a view towards identifying those groups of taxpayers now filing Form 1040 whom we could most easily shift to Form 1040-A without creating additional difficulties for the present Form 1040-A filing population. Possible examples include persons claiming the child care credit, persons who report fully taxable pensions, and persons who claim deductions for contributions to IRA's.

3. Adding the child care credit to Form 1040-A at this late date would create a major reprogramming problem for the Service's 1982 1040-A computer program. While reprogramming could be physically accomplished, the Service would probably opt not to reprogram because of the major risk of introducing serious errors into the program. As a result, the Service could not math verify the computations and a significant revenue loss would be anticipated ($1 million to $5 million).

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname						
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4. It would be necessary to add four pages to the 1040-A tax package. The Service has let contracts to two printers for the 1982 package. One is now at full capacity and cannot print more packages. The other cannot print a package with four more pages due to equipment limitations. Thus, we would have to find a new printer to take over the contract of the second printer and, because few printers can handle the volume we require or have the quantity of paper readily available, we would expect potential delays in printing which might result in tardy shipment of the packages.

5. This year, the Service introduced new Form 1040-EZ. This form will be filed by single taxpayers, subject to certain limitations on types of income, etc., and will enable many millions of filers to prepare a much simpler Federal tax return. Because this major effort at simplifying income tax reporting represents a significant change for taxpayers, the Service believes that we should not further complicate matters by modifying the content of this year's Form 1040-A, except as required by the Economic Recovery Act of 1981.

I hope the above information explains our decision for 1982. I am very optimistic that we will be able to bring many of those claiming the credit over to Form 1040-A for 1982, as well as others whom we would prefer to be able to file the shorter, simpler Form 1040-A.