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Tax reform: Merrill Lynch rides Buffalo Bill

by David Goldman

Sen. Robert Packwood (R-Oreg.) has emerged as the unfortunate frontman for a conspiracy to crash American real-estate and securities values, and permit overseas hot money to buy up the pieces at pennies on the dollar. The Senate Finance Committee's new tax legislation, unanimously passed out of committee on May 7, proposes to shift $100 billion in personal taxes onto business taxes, over the next five years. The maximum tax rate would be reduced from 50% to 27%, and the government would pay for this by throwing out the Investment Tax Credit, accelerated depreciation for real-estate investment, and a host of other deductions.

That fits nicely into the President's own ideological bias, as promoted by the "supply-side" presidential candidate, Rep. Jack Kemp (R-N.Y.). Sources close to Kemp acknowledge a good working understanding between Kemp and White House Chief of Staff Donald Regan, former chairman of Merrill Lynch securities. The former chief of the thundering herd and the former Buffalo Bills quarterback have manipulated the President into backing an utterly monstrous exercise in economic sabotage.

Jack Kemp's job is to exude the aura of popular support for "supply-side" tax cuts, and feed the President's own ideological weaknesses; Regan's role is to appear as the President's biggest sycophant, and force the required policies through the Senate. But the beneficiaries of the tax reform will not be taxpayers, too many of whom will be unemployed to enjoy lower tax rates.

The tax bill will pull the plug on the American banking system, for reasons which ought to be obvious. The near-doubling of U.S. indebtedness to the $8.5 trillion level between 1980 and the present is largely a function of the 1981 tax code, which told business and individuals to borrow as much as they could, and speculate in real estate and financial markets. Investors lined up for real-estate deals based on $20 in equity for $100 in debt, "leveraging" the generous accelerated-depreciation advantages of real-estate investments under the 1981 tax code.

The result is a massive overbuilding, leading to a 25% nation-wide vacancy rate for commercial real estate, a 15% reduction in commercial construction levels between March 1985 and March 1986, and a loan-delinquency rate in commercial real estate in the range of 20%, by *EIR*'s own calculations.

Particularly in states hit hard by collapsing oil prices, the real-estate disaster already threatens to bring down the financial system, starting with savings and loan associations. What the Senate proposes, and what will undoubtedly emerge from conference discussions with the House of Representatives, will make the crash uncontrollable, by eliminating the tax breaks that made real-estate speculation attractive in the first place.

The stock-market bubble runs on the same principles. During the past five quarters, U.S. corporations borrowed roughly $120 billion on the bond market, and used almost all of it to buy up their own stock, through mergers, acquisitions, takeovers, and leveraged buyouts. In other words, corporations were told by their accountants to issue as much debt as possible, since the interest payments could be written off as a business expense; and to use the debt to purchase securities, since dividends and capital gains are taxed at a much lower rate than straight income.

The $100 billion reduction in the amount of corporate equity outstanding is the source of the last year's stock-market boom. In contrast, virtually none of the funds borrowed by the corporate sector got to within hailing distance of a machine tool. The "recovery" took place strictly in the securities markets, while the economy's industrial base continued to decline.

The closing-down of business tax deductions does not have the same immediate, devastating impact that the elimi-

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nation of accelerated depreciation for real estate implies. Nonetheless, it signals a narrowing of corporations' field in which to use tax gimmicks, and the end of the corporate sector's grand plunge into stock speculation.

Real estate and the banking system

Savings and loan institutions reported last September that about $32 billion of their $648 billion of mortgage loans is in trouble. Almost all of this is concentrated in commercial real-estate lending, into which the S&Ls were forced by Paul Volcker's banking deregulation of the early 1980s. The S&Ls took a plunge into high-risk lending, often obtaining 2% or more off the top of the loan as a fee, and used such one-shot income to stave off disaster during 1983, 1984, and 1985. Now the same high-risk loans are failing to earn income, and the crisis has arrived with a vengeance. We obtain a delinquency rate on commercial and multi-family residential mortgages of 19%, as of September 1985.

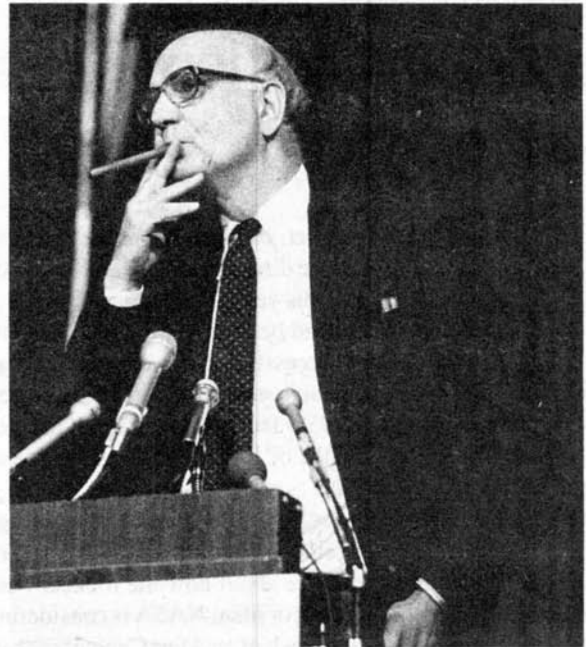
How much bank debt is at risk? The value of commercial real estate may be calculated as follows: Approximately 1.5 billion square feet of prime office buildings exist in the 24 top market areas surveyed by the Office Network. At $22 per square foot average rent, their income-production capacity is $33 billion annually. According to a Price Waterhouse formula of $.855 in rent for every $10 of property, we can estimate a market value in the major market areas of about $386 billion. That corresponds roughly to the existing numbers for outstanding commercial mortgages.

A bad-loan rate of 15% to 20% translates into a $57 to $77 billion loss for the banking system. However, the current vacancy rate of 25% suggests that the loss will escalate, to $96 billion.

The bad news is that nearly $100 billion of bad real-estate debt was on bankers' books by the end of last year. Even *worse* news is that the Packwood tax plan will devalue most commercial real estate by about 40%. That translates into an additional loss of at least $154 billion. The present losses plus future loan losses we can anticipate—as a matter of pure arithmetic—are more than $250 billion, divided about equally between savings institutions and commercial banks. This is sufficient to wipe out the entire banking system.

According to a Price Waterhouse study published in July 1985, when tax reform was still a leer in Don Regan's eye, eliminating accelerated depreciation tax-benefits would wipe out 40% of the value of an 80%-debt-based real-estate transaction, the most typical case for commercial deals.

That is what the tax disaster will set in motion. Who stands to benefit? Donald Regan's Merrill Lynch became a leading conduit for international dirty money seeking havens in the United States, as *EIR* reported in our April 25 cover story. $500 billion in global narcotics traffic is already about two-fifths of world trade. Under crash conditions, it can buy what it wants. Regan and his old Merrill Lynch associate David C. Mulford, now the treasury's assistant secretary for international affairs, are also talking down the dollar—giving overseas hot money both a currency and a price advantage in buying up bankrupted U.S. assets.



NSIPS/Stuart Lewis

Volcker speaking at the Society for International Development.

Volcker won't deny he'd legalize dope

Federal Reserve chairman Paul Volcker refused to deny that he supported the legalization of drugs in developing-sector countries before a shocked audience at the annual meeting of the Society for International Development in Washington, D.C. on May 8. After delivering a half-hour diatribe against the evils of "nationalism" in the name of "painful adjustment, competition and free markets," Volcker was questioned by *EIR*'s correspondent: "The 1986 report of the Inter-American Dialogue, headed by Sol Linowitz, and including the likes of McGeorge Bundy, Robert McNamara, and Cyrus Vance, in supporting the Baker Plan, has called for the selective legalization of drugs in certain developing-sector countries. Do you support that policy?" Volcker threw his arms up. "That's way out of my league. I don't want to get into that," Volcker stumbled. "But do you denounce the policy or not?" our reporter insisted. "I would have to do an awful lot of thinking about it," Volcker, clearly embarrassed, said. "Then that means you would consider it," our reporter retorted. "I just don't want to get into that. Next question," Volcker stammered. A majority of the audience of over 300 were representatives of Third World countries. Cable Network News filmed the exchange.