REMARKS OF SENATOR DOLE

GULF OIL

Monday, January 23, 1984--7:30 P.M.--Ritz Carlton

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 foreseable future, unless drastic action is taken.

- Assuming an extremely strong recovery (4% real growth of GNP) is sustained over the next few years and all of the Administration's proposed spending cuts are made, the deficits are still projected to be:

FY 1985	FY 1986	FY 1987	FY 1988
$185 billion	$195 billion	$199 billion	$179 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 projects deficits would be:

FY 1985	FY 1986	FY 1987	FY 1988
$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 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.

- o Virtually all economists agree that the sustained enormous deficits that we are facing will be economically harmful.

- o 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.

- o 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.

<u>What do you think the Adminstration will propose in its FY 1985 budget to deal the with deficits?</u>

- o Clearly the Administration will repropose many of the domestic spending cuts from its 1984 budget that have not been acted upon.

- o Based on the figures I have seen, the Administration will propose only about $6 billion in net domestic cuts for FY 1985, but that figure is larger in the out years:

FY 1985	FY 1986	FY 1987	FY 1988
$5.6 billion	$13.7 billion	$17.0 billion	$22.1 billion

- o Unfortunately, I am afraid that the effect of these domestic spending cuts will be undercut by proposed increases in defense spending.

- o On the tax side, I do not think it is likely that the Administration will propose some form of contingency tax increase like that included in last year's budget.

- o Thus, at this point I do not see very much in the way of deficit reduction included in the FY 1985 budget Adminstration submission.

<u>What do you propose to do to trim the deficit?</u>

- o The Senate Finance Committee has been working on a deficit reduction package that I hope will gain bipartisan support.

- o The Finance Committee has aimed for $150 billion in total deficit reduction over the next 4 fiscal years, with most of the savings coming in fiscal years 1985 through 1987.

- o The package will have a least one dollar in guaranteed spending cuts for each dollar of revenue increases.

- o The Finance Committee will undertake to provide one-half of the spending reductions, and look to the other Senate Committees to produce an equivalent amount of savings.

- o Any new revenue increases (other than pure loophole closers) will be expressly contingent on certification that spending cuts have been achieved and will be triggered off in Congress later reneges on these spending cuts.

- o As now constituted, this package would involve more in spending cuts than the Administration may propose, but perhaps somewhat less in taxes than if the Adminstration were to simply extend its 1984 contingency tax proposal.

- o The Senate Finance Committee deficit reduction package would reduce the deficit by the following amounts:

	FY 84	85	86	87	Total
Revenue Increase	3.Ø	16.6	24.8	28.5	72.8
Finance Committee Spending Reductions	1.Ø	6.2	11.9	19.Ø	38.1
Other Committee Spending Reductions	1.Ø	6.Ø	11.Ø	19.Ø	37.Ø
Total	5.Ø	28.8	47.7	66.5	147.7

What about defense spending?

- o It is expected the Administration will reccommend $3Ø5 billion in defense spending for FY 1985--a 13% real increase over the 1984 defense spending level.

- o This sharp increase in defense spending is $16 billion over the substantial increase provided for FY 1985 in the most recent Congressional budget resolution.

- o Over the period FY 1985-1987, the Administration's defense recommendation is about $65 billion higher than the 5% real growth path that Congress last year set as adequate for a strong defense.

- o The Adminstration's defense recommendation is a first offer that sets its opening bargaining position. I believe that the final defense number for FY 1985 will be close to the $289 billion figure contained in last year's budget resolution.

- o Even at a $289 billion level, defense spending will have increased 91% since 1981, the first year of the Reagan Presidency.

What about Medicare Cuts?

o From the preliminary information I have seen about the Administration's budget plans, I expect to include many of the same Medicare recommendations that they proposed last year.

o The Senate Finance Committee has reviewed these recommendations and included modified versions of a number of them in its tentative package.

o We should be closely examining Medicare whether or not we have a deficit.

o The most recent Trustees report on the hospital insurance program concluded that under mid-range economic assumption, the HI fund is barely adequate to ensure the payment of Medicare benefits through the end of the decade.

o Under pessismistic assumptions the Medicare fund will be exhausted in 1988.

o The Medicare trustees concluded in order to bring the Medicare system into actuarial balance, expenditures will have to be reduced by 30 percent or revenues into the fund need to be increased by 43 percent.

o Thus, we need to act responsibly to insure the continued viability of the Medicare program.

Note: Trent Lott late this week condemned any Medicare cuts and predicted they would not even be included in the Administration's budget submission.

WHY SHOULD WE ACT THIS YEAR ON THE DEFICIT

o 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.

o 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.

o 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.

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 1.7 million units a year, and new home sales are up by 91% over the recession low.

- Industrial output in 1983 rose 6.5%, and factory utilization is up to 79.4%--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 9.4%--this is a rate about 2% 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 rost just 0.6%--the lowest increase since 1964. The CPI is running at 3-4%, and 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% to 8.2% in December. Overall, this means unemployment has dropped 2.5 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 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.

ROYALTY TRUSTS

Background on Royalty Trusts

A royalty trust is generally formed by carving a royalty interest out of a company's working interest in oil producing properties. The royalty interest is contributed to a trust, and the interests in the trust are distributed to the company's shareholders as an ordinary distribution. Generally speaking, the interests distributed to the shareholders represent highly appreciated property.

Current Law

Under current law, the ordinary distribution of appreciated property does not trigger a tax at the corporate level. Individual shareholders who receive the distribution may pay a tax, depending upon whether the distributing corporation has any earnings and profits. In the case of certain of Mesa's prior royalty trust arrangements, the distribution was tax-free to the shareholders as well.

Individual shareholders receive a fair market value basis in the property distributed to them. Thus, subsequent earnings produced by the royalty interest are largely non-taxable to them as a return of capital.

Proposal

The staff preliminary report on corporate reform and simplification recommended that a corporation be taxed on the distribution of appreciated property to individual shareholders. Thus, there can be no basis step-up without corporate level gain. (The proposal does not change the taxation of distributions to corporate shareholders, which would continue to receive a carryover basis in the property distributed, with no corporate level tax.) The budget deficit reduction proposals before the Committee in November contain the same provision in the Treasury supported proposals.

Talking Points

- Opponents of the proposal contend that it would impose two levels of taxation -- once at the corporate level and once again at the shareholder level. In fact, under current law, no tax is often imposed -- where the shareholder is tax-exempt (e.g., a pension or IRA) or where the corporation has no earnings and profits (e.g., Mesa's prior deals). Thus shareholders have often received a "free" basis step-up in the distributed property. The SFC proposal would merely insure that at least a corporate-level tax would be imposed in order to obtain a basis step-up.

- The Mesa people have generally not challenged the soundness of the proposed rule, but have asserted that more revenue can be raised if the proposal is not effected. We have asked them to prove their assertions.

- The royalty trust scheme also raises questions as to whether the division of operating interests of large oil companies such as Gulf is consistent with our national energy goals. It is unclear whether the development of oil and gas reserves is unaffected by royalty trust arrangements.