REMARKS OF SENATOR DOLE

EXECUTIVE COMMITTEE OF THE NATIONAL GOVERNOR'S ASSOCIATION

Monday, June 11, 1984-- 3:00 p.m.--HALL OF THE STATES

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.
- By 1989 the annual Federal interest cost will amount to $250 billion--about $1,100 for every American.
- That $1,100 per person interest cost is equal to 40% of each person's annual expenditure for food.
- Virtually all economists agree that the sustained enormous deficits that we are facing will be economically harmful.
- 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--and there are signs of that, with the prime rate up to 12-1/2--for each one percentage point increase.
- 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.

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 and revenue proposals are enacted, the deficits are still projected to be:

FY 1985	FY 1986	FY 1987	FY 1988
$180 billion	$177 billion	$180 billion	$152 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 <u>not</u> enacted, the projected 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.

<u>Why should we act this year on the deficit</u>

- If we fail to begin dealing 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 very possible.

- If we postpone any 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.

- 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.

- Rising 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: some of that has already occurred. 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.

Deficit downpayment in 1984

- The President took the lead to begin a deficit-reduction effort in 1984 by calling for bipartisan negotiations on a package to reduce the deficit by $100 billion over 3 years. Then he worked with congressional Republicans to outline a $150 billion package including defense savings ($40 billion), nondefense cut ($43 billion), revenue increases ($48 billion), and debt service savings ($18 billion). As the President suggested, we are working with a variety of modest spending reductions, and tax reforms that raise revenue, to enact a significant deficit "downpayment" in 1984.

o Even though election-year politics makes it difficult to launch the kind of major assault on the deficit that we really need, that is no reason to do nothing. Making a noticeable dent in the deficit will make our job easier in the years ahead. Even more importantly, it will demonstrate that we can face up to the deficit problem even in an election year.

o The Senate has adopted the President's plan, including the Finance Committee's proposals on spending and revenue options that achieve about $7 billion of the "downpayment" goal. To do that we drew on a number of proposals that have been on the table for some time, including some that were already in the legislative "pipeline":

-Items included in the FY 1984 reconciliation bill, S. 2062

-Treasury-endorsed proposals on tax shelters and other abuses

-Administration -proposed spending cuts that were not followed through on last year

-Administrative savings and other proposals made by the Grace Commission

-Additional proposals considered in the Finance Committee last fall

-Grace Commission recommendations ($3.1 billion in the Finance package)

o Feasibility. We have made progress by following the President's suggestion and concentrating on relatively non-contentious items, avoiding things like the third-year tax cut and indexing, mean-tested entitlements, social security, and the like. Our effort must be bipartisan and balanced to do the job: Democrats and Republicans alike will benefit by cooperating to take swift action on the deficit.

o Time of the essence. The House has pased a deficit plan that makes deeper cuts in defense spending, and we are now coferring on the differences. Unless we finish action soon, election year politics may make it difficult to get this job done.

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. And the economy grew at 8.8% in the first quarter of 1984.

- Housing starts are running at a rate of about 1.96% million units a year, and jumped 19% in February.

- Industrial output in 1983 rose 6.5%, and factory utilization is now up to 81.9%--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 16%--this is higher than that seen at comparable points in previous postwar recoveries. And the 12% increase expected this year is the highest in 18 years.

Inflation

- The best news about this recovery is that it is noninflationary. In 1983 the producer price index rose just 0.6%--the lowest increase since 1964. The CPI for 1983 was 3.8%, the lowest since 1972. 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% last November to 7.5% in May. Overall, this means unemployment has dropped 3.2 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 <u>5.5 million</u> 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.

HIGHLIGHTS OF SENATE DEFICIT REDUCTION DECISIONS

(Savings estimates are for period 1984-87, and include outlay savings in S. 2062)

Spending Restraint

- Medicare Part B Premium. Stablize the premium as a percent of program costs between 1985 and 1990. ($1.2 billion)

- Delay initial Medicare eligibility until month after an individual's 65th birthday. ($630 million)

- Working age. Non-working spouses age 65 to 69 could elect primary medical coverage under spouse's employer health plan rather than Medicare regardless of working spouse's age. ($1.1 billion)

- Physican freeze. Continue until July 1986 a freeze on physican's fees for those unwilling to accept assignment for all services to Medicare patients. ($2.8 billion)

- Fee schedule for lab services. Payments for clinical lab services would be held at 62 percent of prevailing charge levels through October 1987 ($1.0 billion)

- Limit on hospital costs. For FY 1985 and FY 1986 increases in hospital cost payments under Medicare would be limited to one-half percent less than the hospital wage and price index increase. ($1.1 billion)

- Grace Commission. Improved cash management techniques (e.g. faster deposits of receipts to the government), improving income verification procedures for benefit programs, and using IRS refund offsets to collect debts owed the government would be implemented. ($3.1 billion)

- Debt service. $9.6 billion.

Revenue Increases

- Tax reform. New rules would be applied to limit tax shelters in such areas as partnership allocation of expenses and income interest deductions on discount obligations, transactions between related parties, current deductions for future liabilities, and corporate deductions for extraordinary dividends received. ($10.2 billion)

- Tax benefits. Where a taxpayer receives a refund or other recovery for State taxes or other situations that previously gave rise to a deduction, the tax benefit portion of the deduction would be brought back into income first. ($800 million)

- Real Estate. Depreciation rules (20 years for all structures in FY 1984, 19 years in FY 1985, 18 years in FY 1986 and thereafter, new or used), and recapture rules for real property would be adjusted. ($4.4 billion)

- Freeze. Expensing for small business investment would be frozen at $5,000, the cost of used property eligible for the ITC would be frozen at $125,000, and the foreign earned income exclusion would be frozen at $80,000. ($1.9 billion)

- Distilled Spirits. Federal excise tax would be increased $2.00 per proof gallon ($1.0 billion)

- Income Averaging. The base period for determining the income averaging threshold would be reduced to 3 years and the formula slightly modified. ($1.6 billion)

- Earnings and Profits. The definition of earnings and profits would be modified so that it more closely reflects a corporation's economic income rather than its taxable income. This change will reduce a corporation's ability to pay tax-free dividends. ($1.7 billion)

- Add-Ons. In addition to miscellaneous items, the Committee agreed to phase in spousal IRAs; an R&D package; foundation tax changes; extend the targeted jobs credit for 3 years; enterprise zones; increase the earned income credit; Foreign Sales Corporations; energy credit extension with credit reordering; and others.

March 23, 1984

PRELIMINARY ESTIMATES OF THE SENATE FINANCE COMMITTEE PACKAGE

SPENDING	1984-87 Total (Savings in $ billions)
Reconciliation (S. 2062)	
Finance Committee provisions	3.8
Additional Spending Reductions	
*Part B Premium	0.4
*Delay in Initial Eligibility for Medicare	0.6
Working Aged	1.1
*Physician Freeze	0.8
Hospital Market Basket	1.1
Lab Fee	0.9
Medicaid Reduction	1.4
Alcohol Rebate	0.9
Revaluation of Assets	0.3
Lesser of costs of charges	0.3
Competitive Bidding/Claims	0.1
Round Part B Payments	0.2
SNF Rates	(0.1)
Grace Commission	3.1
Debt Service	9.6
Total	24.5

	1984-87 Total (in $ billions)
Reconciliation Tax Provisions (S. 2062)	21.4
Additional Revenue Items:	
Tax shelter, accounting abuse, and corporate reform	10.2
Tax Federal Home Loan Mortg. Corp.	0.3
Tax benefit rule	0.8
Alcohol and tobacco collections	0.5
Freeze ACRS expensing, ITC for used prop. and foreign income exclusion	1.9
Postpone finance lease rules	2.7
Extend telephone-excise tax	3.2
Modification of Sec. 1231	0.2
Factoring of trade receivables	1.4
Source of shipping income	0.2
Recharacterization of U.S. income as foreign source income	0.3
Trust distributions	0.7
Income averaging modification	1.6
Delay in ESOP	0.4
Corporate preference exclusion increase	0.5
Increase distilled spirits tax	1.0
Deferred rent on real and taxable property	1.7
Repeal dividend reinvestment	0.4
Installment sale recapture rule	0.2
20-year life for structures	4.2
Other miscellaneous revenue increase proposals	2.6
Major Revenue Loss Provisions:	
Spousal IRAs	-.9
Enterprise zones	-1.3
R&D credit extension and expansion	-2.0
R&D foreign source allocation	-0.2
Targeted jobs tax credit	-1.6
Life insurance tax change	-1.3
Earned income tax credit	-0.4
Mortgage revenue bond extension-IDB package	-0.6
Grand Total	$48.1

MEDICAID REDUCTIONS

- The savings estimates for the Finance Committee proposal are:

1985	1986	1987	Total
-$562	-$353	-$432	-$1,347

- The States' capacity to absorb federal Medicaid reductions has been bolstered by Federal economic policies. A strong economic recovery during 1983, together with further state tax raising activities, have resulted in State treasuries having a surplus rather than a deficit. An article, in the April 17 Business Week entitled "an embarrassment of riches for the states", documented this trend. Even Michigan, one of the States that was hardest hit by the recent recession, closed fiscal year 1983 with a $24 million surplus in its treasury.

- From mid-1982 to mid-1983, state-local receipts grew by 9.6 percent, nearly twice as fast as the 4.9 percent rise in Federal receipts. On the other side of the ledger, state-local spending grew by only 5.5 percent, less than half the 11.3 percent increase in Federal expenditures. In 1984 state revenues will grow by an estimated 9.7% while there will only be a 7.2% growth in expenditures.

- Clearly, some of the most important factors responsible for the healthy fiscal status of the States include the many statutory tax hikes that States have implemented since 1982 following a decade (1972-1982) in which state-local tax growth lagged behind increases in personal income. Nationwide, general taxes at state and local levels of government dropped from $128 per $1,000 of personal income to $111 per $1,000 -- down about 13 percent for the decade.

- Many governors and legislators are beginning to call for tax cuts because of the surplus situation in which they find themselves. but not all of the state revenue windfall is being used to justify tax cutbacks. Some states are expanding emergency reserves and others are again increasing expenditures for certain services.

- The Finance Committee provision in the Deficit Reduction Act would extend the existing medicaid reductions and offset provisions for three years. The reduction rate would be 3% for FY 1985, FY 1986, and FY 1987. Under this proposal in the coming three fiscal years: Six States are expected to qualify for hospital cost control offsets (Connecticut, Maryland, Massachusetts, New Jersey, New York, and Rhode Island); Two States (Michigan and West Virginia) are expected to qualify for offsets under the unemployment provision; and a number of States representing 25% of expenditures would qualify for the fraud and abuse offset.

- Contrary to earlier dire predictions, the Medicaid reductions that States have absorbed since 1982 have not resulted in a weakened Medicaid program nationwide. Of the 20 States considering some changes in eligibility in 1984, two-thirds will probably expand coverage or add certain groups. Clearly when the obra reductions were first implemented, the states reacted quite strongly by limiting either benefits, eligibility or reimbursement. By 1982 however, changes were made to both expand and limit the program.

- For example, eleven states put limits on hospital length of stays, 13 states reduced or limited the amount, duration and scope of services, 8 states tightened eligibility criteria, and 6 states eliminated coverage for 18-21 year olds. On the other hand, 13 states added new services and 5 states extended coverage to pregnant women or certain categories of children.

- In 1983 the number of changes were moderate. three states restricted eligibility, while 14 states expanded eligibility. Fifteen states added some new services, while 8 states reduced previously imposed limits on services.

- In response to States' concerns regarding the reduction of Federal Medicaid matching funds, the Congress also included in OBRA two Sections which gave States greater flexibility, through waiver authority, in the administration of their programs. Section 2175 gives States a new flexibility to negotiate with provider groups who will treat Medicaid recipients, and Section 2176 allows States to cover, under waiver authority, a broad array of home and community-based long term care services not previously reimbursed under Medicaid.

- States have responded enthusiastically to the waiver authority granted under OBRA. By the beginning of March, 1984, 24 States had requested so-called "freedom of choice" waivers under Section 2175, and 15 States received approval of their waiver applications. The majority of these approved programs will bring a primary care case management system to Medicaid recipients. Medicaid recipients are allowed to select a provider from whom they would receive primary care, and in turn, this provider would be responsible for coordinating all other care the individual requires.

- We are asking all other aspects of the economy to bear the burden of cost reductions. Why should the states be exempt? Through these provisions we are not asking a great deal from the states, particularly at a time when their financial houses are in better shape than the federal government's.

June 11, 1984

State Relief From Error Rate Sanctions and Loan Repayment

- I am well aware of the serious controversy surrounding the error rate sanctions in three of our largest public assistance programs--medicaid, food stamps, and AFDC. It is certainly possible that the quality control mechanisms used to determine the level of error in each program may be flawed. However, I do believe that it is important for the States and the Federal Government once and for all to take the appropriate steps to demonstrate some State responsibility for these continuing high error rates.

- I wish to remind you that there is already a long history of delay in the imposition of error rate sanctions. For example, in the AFDC program, the first departmental regulations on quality control were issued in 1972 and effective on January 1, 1973. Republican and Democratic administrations alike have waived or suspended penalties on the States.

- The current Administration, in fact, has granted significant waivers to individual States and waived all errors associated with AFDC changes which were a part of the 1981 reconciliation bill and the 1982 tax bill. Not one penny has been collected by the Department of Health and Human Services as a part of the error rate sanction program.

- Under current law, the Federal Treasury expects to collect some $2 billion in food stamp, medicaid, and AFDC error rate liabilities for the period fiscal years 1984-1989.

- This year it appears that the administration will impose sanctions in a number of cases. I understand a substantial number of waiver requests are currently being considered and some may in fact be granted by the Department.

- I do not oppose this waiver process. However, I do oppose the provision contained in the House deficit reduction legislation which would grant the States yet another reprieve from the payment of error penalties. Given the history of delay which marks the Federal-State relationship in this area, I believe that the Congress will grant further delays in the future. The States must be convinced that the Federal Government is serious in its efforts to collect these liabilities. We all have an interest in reducing the Federal deficit.

- Congress is frequently reminded by the governors that we have the responsibility to take actions which will reduce Federal spending and bring the budget closer to balance. I say that the governors can help in this effort by improving State Administration of programs in which the Federal taxpayer either shares the cost--as in AFDC and Medicaid--or pays the entire cost as in the food stamp program.

Unemployment Loan Relief

- The Finance Committee also has been receptive to State requests for Federal relief in a number of areas over the last three years. Many of the governors urging us to reduce the deficit are the same governors who came to the Finance Committee seeking relief from the interest and repayment requirements for unemployment compensation loans and now from the error rate sanctions. At some point, we must take the interests of the taxpayers into account.

- For years Congress has provided relief for States with unemployment loans. Relief, deferral, and interest rate reductions have been substantial.

- Without this relief, State repayment and interest liabilities would have totaled $2 billion for this fiscal year, according to Department of Labor actuaries.

- So I would just suggest that Congress has not turned a deaf ear to State calls for fiscal assistance or relief in a number of areas. Now, we need some help from the States in this effort to reduce the budget deficit. Simply calling on Congress to act is not enough.