REMARKS OF SENATOR DOLE

INSURANCE INFORMATION INSTITUTE

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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 not 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.

Why should we act this year on the deficit

- 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.

- 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.

- 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)

- 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.

- 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.

PROPERTY/CASUALTY INSURANCE TAXATION

DEFICIT REDUCTION ACT

Foreign Insurance Issues & Self-Insurance

Resourcing Rules

- A provision in the deficit reduction package that was accepted by the Conference committee changes the rules governing the U.S. or foreign source of a taxpayer's foreign insurance income and may affect the taxation of foreign insurance operations.

- The purpose of this provision is not to discourage bona fide insurance operations abroad but to make sure that taxpayers do not shift passive funds abroad merely to improve their foreign tax credit position.

- I anticipate that in the near future we may be further examining the uses and misuses of captive insurance companies that are established both in the U.S. and abroad, to insure that any company receiving the tax benefits of an insurance company truly provides insurance.

- Difficult issues to be faced in this area include the determination of the degree of risk spreading necessary for true insurance, and the economic questions of how we can encourage the industry to cut its costs.

Excise Tax on Foreign Insurers

- The Deficit Reduction Act also contained a revision of the excise tax imposed on foreign insurers who insure U.S. risks. The proposal, which was not adopted in Conference, would have imposed a 4% excise tax on the insurer who ultimately bears the insurance risk.

- United Kingdom insurers had argued that this provision conflicts with the U.S.- U.K. tax treaty. Treasury researched the issue and determined that no treaty violation exists, but they were concerned that an "informal" agreement with the U.K., not reduced to writing, might have been made during negotiations on the U.S.-U.K. treaty.

- The Conferees noted that the Treaty was not violated, but agreed to forego the provision at this time in order to further study the impact of the provision.

- At the same time, the hope was expressed that hearings would be held on the effect of the treaty (and any simultaneous agreements) on U.S tax policy.

- However, under present law compliance is very difficult to monitor, and the Senate cannot be expected to be bound by agreements not included in the body of a treaty and not ratified by the Senate. The system provided in the Senate bill which would, in general, collect the tax when premiums are paid by the domestic insurer and be refunded if the foreign insurer showed that it retained the risk and also was eligible to receive relief from this tax pursuant to a treaty, would have a better chance of being enforced.

Deficit Reduction Act and Implications For Property/Casualty Insurance

- Although the basic income tax laws affecting property/casualty companies was not directly affected by the deficit reduction proposals in either the Senate or the House, the industry should pay attention to certain trends and theories reflected in this proposed legislation.

- For example, the accounting proposals emphasize two important tax policy concerns: the mismatching of income and related expenses and a recognition of the importance of the time value of money.

- In very general terms, these concerns deal with the use of the tax code either to accelerate deductions, even though, as an economic matter, the taxpayers have not yet incurred expenses, or to defer income, although the taxpayer may have actually received an economic benefit.

- Thus, for example, the so-called "premature accrual" provisions of the Deficit Reduction Act attempt to limit the ability of a taxpayer to take a deduction for an expense to be incurred in the future, since the value of that deduction is overstated because it exceeds the present value of the future expense.

Potential Application to the Property/Casualty Industry--GAO Report

- The Finance Committee held hearings on the tax treatment of property/casualty companies in June of 1983.
- At those hearings, and in a report that should become final this month, the General Accounting Office stated that the expenses incurred by the industry may be overstated.
- Two of GAO's concerns dealt with the mismatching of income and expenses and with the time value of money.
- Income and expenses may be mismatched, the report stated, because expenses incurred in the sale and renewal of premiums were decucted immediately and not matched with the premium income later earned on the contracts.
- The most controversial aspect of the report is GAO's conclusion that the reserve levels (and resulting deductions) maintained by the industry are too high because they are booked when the claim is incurred and not discounted to reflect the fact that some claims will not be paid for many years.
- Potential legislative responses to this problem could include discounting reserves for all or for at least some of the "long-tail" lines of insurance issued by the industry. Exemptions could be provided if claims are normally paid over a short period of time.
- Although some industry representatives have maintained that current practice is necessary in order to cover future losses, assets can be increased by other means--such as charging adequate premiums rather than relying on the federal government to subsidize insurance costs.
- While Congress should be sympathetic to the difficulties faced by the property/casualty industry, I feel it is likely that its current system of taxation will be reexamined along with a consideration of the GAO report.

Use of Tax-Exempts By the Industry

- The GAO report indicates that, had its discounting of reserves proposal been in place in 1982, revenues ranging from $500 to $600 million could have been raised in that year.
- Many industry representatives, as well as the GAO, have pointed out that little or no revenue may be obtained from

any accounting changes affecting the industry because the companies would reduce their tax liability by investing in tax exempts and dividends subject to the corporate 85% dividends received deduction.

- If Congress does decide that it is appropriate both to reform the industry's accounting procedures and to assure that these companies maintain a certain minimum effective tax rate on their income then it will be necessary to examine the industry's use of tax exempt investments including corporate dividends.

- A possible area to examine would be the rules that govern the life insurance industry requiring tax-exempt income to be prorated between amounts set aside for policyholders and the company. This proration rule, in effect, limits the advantages of investing in tax exempts to life insurance companies.

- Any examination of the use of tax-exempts must, of course, take into account the effect of any legislative changes on the market for tax-exempt issues.

- Whatever changes may occur, it should be emphasized that any income tax changes would not impact companies which do not have economic income. While an excise tax such as a premium tax could adversely affect companies in a loss situation, an income tax will have no impact on a company without income.