REMARKS OF SENATOR DOLE

HOGAN & HARTSON CONGRESSIONAL BREAKFAST

Tuesday, March 19, 1985 -- 7:30 a.m.

Wintergarden Room--Watergate

1. The 99th Congress

- We face major challenges on the deficit, national defense (including the MX), tax reform, Central America. We can meet these challenges by working with President Reagan on the basis of mutual respect.

- Congress knows that President Reagan's overwhelming election victory sent a strong message about what the people expect us to do. We are hard at work on his agenda, but success will depend alot on mutual recognition that Pennsylvania Avenue is a two-way street.

- Our top priority is to cut spending to reduce the budget deficit. That is why Senator Domenici and I introduced S. 1, which commits us to getting the deficit down to $100 billion or less by 1988. The vital issue of tax reform should proceed on a separate track to allow us to sort out the options and see if we can build a consensus without losing momentum on the urgent problem of the deficit. Other issues that require attention in 1985--a new farm bill, Superfund, national defense, and arms control--will not be neglected.

2. Our Economic Progress

- Economic recovery remains on track and is moderating to a pace that can be sustained in the years ahead. Real GNP grew 6.1% in 1983, and continued at 6.8% in 1984, peaking at a 10.1% rate in the first quarter last year. That is the highest real growth rate since 1951. This remains one of our strongest recoveries.

- With national unemployment down to 7.3%, this recovery has created over 7 million jobs. More people are working than ever before. Factories are operating at the highest capacity levels in 4 years, close to 82%. Housing starts in January rose 15% to an annual rate of 1.83 million.

- The best news about this recovery is that inflation is staying low. Producer prices in 1983 showed the smallest increase since 1964. The CPI rose just 3.8% in 1983 and 4% in 1984. We can sustain strong growth with low inflation: especially if productivity keeps rising, as it did in 1984--by 3.6%.

- Growth, lower inflation, and major tax relief have increased real personal income by over $116 billion since 1982. Real after-tax incomes grew 6.8% in 1984--the biggest increase in over a decade.

- Trends in the economy still look good. The prime rate--which rose from 6.5% to 21.5% under Carter-Mondale--stands at 10-1/2%. The misery index, which peaked at 24.5% in March of 1980 is around 11%.

3. The Budget And the Deficit

Nature of the Deficit Problem

- After several years of budget deficits that approached the $200 billion mark, some people seem to be getting complacent about the problem. Since the economy has continued to do well, with low inflation and strong growth, why worry about the deficit?

- The answer is that everything we have achieved for the economy in the last several years is put at risk unless we deal with the deficit. And part of the problem is that the public can't get very excited about the deficit dilemma. It seems we need to have a crisis on our hands, or some kind of visible faltering in the economy, to convince people of the urgency of reducing the budget deficit.

The Real Point

- Sustained deficits in the $200 billion range pose an imminent threat to the recovery, because they will lead to either higher inflation or slow growth and rising unemployment. Without assurance that inflation will remain under control, and credit available at acceptable rates of interest, business will not expand through new investment, and jobs will not be available for our sons and daughters when they are ready to enter the workforce.

What Needs to be Done

- The sacred cow is a thing of the past: everything in the budget must be scrutinized for possible savings. We have not done all we can to reduce Federal spending when the budget still represents nearly 25% of the gross national product.

Spending "Freeze Plus"

- The President's FY 1986 budget proposes to freeze total spending plus reform some programs and terminate others that have outlived their usefulness. That would cut $50 billion from the deficit next year: the minimum we need to sustain a healthy recovery, according to Paul Volcker and other experts.

- Congress will change some of the President's budget priorities, for example, by cutting a bit more from defense. And Senate Republicans want to go a little further in the outyears to get the deficit down to 2% of gross national product by 1988.

- In the Senate, we are trying to put together a major spending cut package. The Budget Committee agreed to a "freeze-plus" including reforms out of the President's budget and our committee chairmen indicated earlier they could do about 60% of the needed domestic cuts--contingent on getting a balanced package that includes defense. We are still working on an expedited schedule and hope to have a budget approved this spring.

Budget Committee Budget

- The Budget Committee proposal would reduce the deficit by $55 billion in 1986, $99 billion in 1987, and $142 billion in 1988. The 1988 deficit would be just over $100 billion, close to our 2 percent of GNP goal: only $3 billion short.

- Defense would get only an inflation adjustment in 1986, and rise by 3 percent in the other years.

- Most non-means tested COLAs would be frozen, including social security.

- Many of President Reagan's program reforms are included, some of them with modifications: Amtrak subsidies would be cut but not ended, for example.

Popular Support

- The people want spending cut. The Los Angeles Times poll shows that by a 5 to 1 margin, Americans prefer cutting government spending over tax increases to deal with the deficit.

- The Gallup poll shows that 54% of Americans believe the deficit is a very serious problem: but it's tough to translate that into action because the public has varying views on which spending should be cut.

- Experts also agree that spending reduction is the way to go. In January, distinguished experts such as Alan Greenspan, Charles Schultze, and Martin Feldstein told the Finance Committee that cutting spending by $50 billion or more in 1986 will reduce interest rates, keep inflation down, and ensure continued recovery. Paul Volcker says that is the least we need to do on the deficit.

Risks Ahead

- Time is of the essence, because we are at the point where economic expansion will either continue, competing against heavy Treasury borrowing, or the recovery will slow and possibly slip into recession. That is why Senate Republicans moved ahead of schedule to work out a budget plan. The risk is that the deficit problem will compound itself: each year that we add $200 billion in new Federal debt adds about $15 billion to the next year's interest costs. The exploding cost of servicing the Federal debt will make controlling spending that much more difficult each year.

All Aboard

- Everyone must share in the effort to close the deficit gap. People will accept a limited, short-term sacrifice for fiscal restraint if they understand that it is the best investment they can possibly make for their own, and their families', economic future.

4. Major Tax Reform

- The Treasury Department has proposed an innovative, constructive new plan for reforming our tax system, and the President made tax reform a high point of the State of the Union address. Some of the proposal is highly controversial, and the President no doubt will modify some things. The Treasury initiative provides an excellent starting point for the 1985 tax reform debate.

- Under the Treasury plan, there would be just three tax rates: 15, 25 and 35 percent. The personal exemption would double, to $2,000. Rate brackets, the zero bracket, and the personal exemption would continue to be indexed. For corporations, there would be a single rate of 33 percent.

- o Major tax breaks that would be dropped include the deduction for State and local taxes, the marriage penalty offset, the investment tax credit, the capital gains exclusion, the tax exemption for private purpose bonds, and the exemptions for employer-provided fringe benefits.

- o Tax provisions that would be modified include mortgage interest deductions for second homes (disallowed); the charitable deduction (limited to amounts in excess of 2 percent of adjusted gross income); business expense deductions (limited); and taxation of dividends (a partial dividends-paid deduction).

- o Indexing would be extended to capital gains; interest income and expense; depreciation deductions; and the earned income tax credit.

- o It is important to build a consensus for any far-reaching changes, drawing on the Treasury plan, Bradley-Gephardt, Kemp-Kasten, and other plans. It may be necessary to move gradually, and reform will not be possible without strong Presidential leadership. And the people will have to let us know if they think the kinds of trade-offs being proposed are worthwhile.

5. International Trade

- o Another major challenge is to keep international markets as free and open as possible in an era of record U.S. trade deficits. Reducing the budget deficit will be a tremendous help, because it will help moderate interest rates and the value of the dollar.

- o So far we have done well in keeping avenues of trade open. It is especially significant that last year's trade bill extended for 8 1/2 years, the Generalized System of Preferences, which provides duty-free treatment for certain imports from the underdeveloped world.

- o In a similar trade liberalizing vein, the bill authorized the negotiation of free-trade zones, specifically with Israel, and the reciprocal reduction of tariffs on semiconductors.

- o It is hoped that the authority to negotiate bilateral free trade arrangements may induce other countries to join in trade liberalization.

- The trade bill recognized, for the first time, the importance of trade in services (including banking); The President is directed to negotiate reduction in barriers to trade in services (a sector in which the U.S. has the competitive advantage and which represents a major portion of our GNP.)

- At the same time, the U.S. must be prepared to use what leverage it can when markets are unfairly closed to American producers. That is why we are reviewing overall trade relations with Japan to help remove artificial barriers to American entry to the Japanese market.

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1. Prospects for a Tax Bill

   - The Administration is expected to send its tax reform proposal to Congress in the next month or two. Early hearings are likely in both the House and Senate.

   - There is a lot of interest in tax reform and there could be considerable momentum if the President pushes hard for action.

   - At the same time it will be difficult to give tax reform the kind of full-time attention it deserves until the budget deficit problem has been dealt with. Swift Congressional action on a spending-cut package is critical if we want to spend time on tax reform.

   - There will be some revenue legislation to deal with this year anyway, because we have to renew Superfund and attend to some expiring provisions: the targeted jobs credit, and the research and development credit.

2. Research and Devlopment Credit

   - The R&D credit, originally passed in ERTA, expires at the end of this year. The Reagan Administration proposes to extend it for three more years, which would reduce receipts by $3.5 billion over that period.

   - Last year the Senate version of the Deficit Reduction Act included a provision to make the R&D credit permanent and modify the definition of qualified expenditures to redirect the credit towards technological improvements and innovative, functional changes in a product or process. This provision was rejected by the House in conference.

   - The R&D credit will compete with other credits for possible extension this year. There is still a lot of interest in it, although it is still very difficult to define for tax purposes the kinds of expenses we want to encourage. The Treasury tax reform plan would keep the R&D credit but reform it for better targeting to productivity improvements.

3. Import Surcharge

   - Some have proposed an across-the-board surcharge on imports to deal with both the budget deficit and the trade deficit. The notion is that we could both raise substantial revenues and reduce the price disadvantage American goods have because of the high value of the dollar.

- Obviously an import surcharge is a very risky idea. No one disputes that it would increase costs to consumers and raise the threat of protectionist retailiation from our trading partners: and it is one type of tax increase.

- At the same time, the import surcharge idea is unlikely to go away while we have such a large trade deficit and such acute market-access problems as we have with Japan. Our trading partners who are concerned about a surcharge should help us reach agreement on fair trade practices and market access so we can hold off extreme remedies like an important surcharge.

MAJOR MEDICARE PROVIDER BUDGET SAVINGS INITIATIVES

Proposal	3-Year Savings
o Freeze Payments to Hospitals	$6.9B
o Reduce Medical Education Financing (Direct and Indirect)	$4.2B
o Freeze Physician Fees for One Additional Year	$1.3B

1. Hospital Payments

Concern raised that freeze will put some hospitals at serious financial risk. Paul Rogers may raise particular concern regarding hospitals serving a larger number of low income medicare patients or indigent patients.

- All other aspects of the budget are being considered and medicare must be included in deficit reduction efforts. Hospital expenditures account for approximately 64% of medicare's outlays, and continue to increase at rates in excess of increases in the economy as a whole. Most hospitals can cope with a one year freeze.

- o However, given the liklihood of a one year freeze consideration should be given to the benefits or problems with slowing down the rate of transition to the new nationwide DRG system. Higher cost regions could be particularly hard hit by a freeze combined with a continiued movement towards single national DRG rates. Discussions are just beginning to take place on this subject and the outcome not yet clear.

- o Efforts are also underway to isolate and validate the costs incurred by hospitals that serve a large number of low income medicare patients and consideration is being given to ways to assist them along with very small rural hospitals who are also in some cases experiencing problems as a result of the new DRG system.

- o We knew at the outset that the prospective payment system was not perfect but tremendous progress has been made, rates of admissions are down as are lengths of stay. Further work needs to be done to correct problems that have been identified, for example the lack of a method of accounting for differences in the severity of certain cases, but we are on the right track.

- o Work is being done to solve the remaining issues with the DRG system, for example the inclusion of capital costs, but we still have a ways to go. We are not likely to be able to resolve them all within the next few months, but I fully expect the Finance Committee Health Subcommittee to hold hearings on a broad range of subjects including reimbursement for capital costs, creation of a severity index, and adjustments for hospitals caring for a large number of low income medicare patients.

2. <u>Physician Payments</u>

- o As with all other aspects of medicare, reductions will also be sought from the physician portion of the program. The Administration has recommended a one year extension of the freeze on physican fees. We are aware, however, of the commitment made by those physicians who became medicare participating physicians as a result of the changes contained in DEFRA. The Budget Committee suggests that we provide them some limited increases in fees while freezing everyone else.

- o As a result of the particpating physician program, physician medicare assignment rates are at an all time high, and large numbers of the elderly are protected from additional out of pocket costs. While keeping in mind our deficit reduction goals, we must take care not to discourage those physicians who have been of assistance and shown restraint in not passing along costs to the elderly.

3. Medicare Financing of Medical Education Costs

o Because of the crisis with both the deficit and the long range financing of medicare we must reexamine medicare's commitment to finance medical education. While believing in the value of these expenditures, I believe there may be ways to restrain these costs.

o We are currently considering a change in the way we pay for direct medical education expenditures (those funds that finance the salaries of medical residents and others involved in a hospital based teaching program). We might, for example, limit the number of years of a residency we would pay for rather than simply capping the total amount of money spent. My staff is meeting with representatives of the Administration and the medical education community to review these options. No final decision has yet been made.

o With respect to indirect medicare education costs, the Administration proposal is under consideration by the Finance Committee and have been recommended by the Budget Committee. Clearly some reduction may well make sense. However, we are of course aware that one of the reasons we increased this expenditure, in 1983, was to help teaching hospitals deal with higher costs that may be attributable to them having sicker patients or poorer patients. We are still concerned with these problems, and are trying to determine a way to fine tune the so-called "teaching adjustment".