United States Senate

COMMITTEE ON FINANCE

WASHINGTON, D.C. 20510

September 16, 1983

TO: Senator Dole

FROM: George Pieler

SUBJECT: Metropolitan Insurance talk

Attached are an outline of remarks, and materials on life insurance taxation and gender discrimination issues in insurance, as well as some background on the participants in the Sunday dinner and on Metropolitan's business in Kansas.

Phil Ufholz indicated that some remarks regarding the company's cooperation during TEFRA, and the industry's support on withholding, would be appreciated.

Attachments

United States Senate

COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

September 16, 1983

M E M O R A N D U M

TO: SENATOR DOLE

FROM: RICH BELAS

SUBJECT: METROPOLITAN LIFE

Metropolitan Life Insurance Company is the second largest life insurer by asset size. Like many of the mutual insurance companies, Metropolitan strongly objected to the original Stark-Moore proposal because they believed it would raise their taxes substantially more than stock life insurance company taxes would be increased.

Because a mutual company has only policyholders but no stockholders, the big issue is how to determine what portion of a mutual company's income is comparable to the return on equity for a stock company's stockholders (which should be taxable) and what portion is appropriately apportioned to its policyholders as customers.

It is a political question as well as a theoretical one because how this factor is treated will determine the balance of tax burden between the stock and mutual companies.

Metropolitan has also been a major critic of the Stark-Moore approach because, unlike some other large mutual companies, they have retained comparatively more earnings in the company rather than distributed the earnings as policyholder dividends. The accumulated funds adversely affect them under the Stark-Moore formula for determining mutual company tax liability. The latest draft of the Stark-Moore bill attempts to address some mutual company concerns. I have not been able to find out whether the changes have had any significant impact on the mutual company's attitude toward the bill.

One additional point that might be worth stressing is that, although the Stark-Moore approach is designed to tax life companies on close to true economic income, political compromises on the House side could reduce expected revenues substantially. If the proposal loses revenue compared with current law and contains too many special interest complications, there would be little reason to enact the legislation, considering that many companies will be unhappy if there were any redistribution of the tax burden which increased their taxes even if the proposal were there revenue neutral in the aggregate.

RB:c

Attendees for Sunday Evening Dinner with Senator Dole

Richard Shinn - Retired Chairman and CEO

Dick served with the company for 44 years.

John Creedon - President and CEO

John has been with the company for more than 40 years.

Stewart Nagler - Executive Vice President

Responsible for group pensions, company tax policy, actuarial and corporate planning. Stu has been with the company for over 20 years.

Thomas Stapleton - Vice President and Director of Taxation

Responsible for all company tax matters. Prior to joining Metropolitan in 1973, Tom served as Trial Attorney and later Assistant Chief of the Appelate Section in the Tax Division of the U.S. Justice Department. He tried and argued many of the cases involving the interpretation of the 1959 Life Insurance Company Tax Act.

Vincent P. Reusing - Vice President for Government & Industry Relations

Vince joined the company in 1969 and is the head of Metropolitan's Washington office.

Philip J. Ufholz - Vice President for Government & Industry Relations

Phil joined the company on June 1, 1983 and works with Vince Reusing in Metropolitan's Washington Office. Prior to joining the company, Phil served as tax counsel to Senators Gaylord Nelson and William Roth on the Senate Finance Committee.

THE ROLE OF METROPOLITAN
IN THE ECONOMY OF KANSAS

The Metropolitan Insurance Company has contributed for many years to the growth of the Kansas economy in its role as employer, purchaser, taxpayer, investor, and insurer. These contributions will continue to accompany future operations in the state.

As an employer, our Kansas facilities numbered 10 in 1982 and included: an Electronic Installations Center at Wichita, the head office for Agricultural Investments and a Group Insurance regional office at Overland Park, and sales offices throughout the state. Wage and salary employees of the Company working in the state totaled 395 in 1982. In addition 55 sales personnel operating on a commission basis are located in the state. Such employment makes a desirable contribution to the stability of the economy of Kansas since much of our business is noncyclical in nature. Jobs generate income for individuals and Metropolitan employees in the state earned about $9.1 million, exclusive of commissions on existing business. Additional income was generated through purchases of goods and services by the Company, including such items as electric power, rent, security and maintenance services, and telephone and banking facilities. These numbers do not include employment and outlays resulting from our partnership and joint venture operations within the state.

As a business operating in Kansas, Metropolitan paid $893,000 in state taxes, licenses, and fees during 1982. Most of this reflected levies on life and health insurance premiums and annuity considerations received. The figures do not include other revenues flowing to the state from the income and sales taxes paid by our employees or taxes paid by our joint ventures, partnerships, or subsidiaries.

Metropolitan Life investment holdings included $501 million allocated to the state of Kansas at the end of 1982. About $183 million of this total represented corporate stocks and bonds used to finance productive facilities that contribute to the economic well-being of the state and its residents. Another $233 million has been provided for residential, commercial, and farm mortgages, while $28 million is invested in real estate directly or via partnerships and joint ventures. To facilitate Company operations, relationships are maintained with three major banking institutions.

Metropolitan Life has been active as an insurer in Kansas for many years. The combined amount of life insurance in force under both personal and group lines was $2.4 billion at the end of 1982. About 292,000 state residents, or one in eight, were covered by various life, health, or annuity products at the start of the year. Benefit payments in Kansas totaled $36 million, including $25 million to living policyholders, during 1982.

The multiplier effects of Metropolitan operations on the economy of Kansas are greater than the amount of our direct spending within the state. Our payments to employees and suppliers sustain further outlays by these recipients. The $10.2 million spent directly by Metropolitan Life just for payrolls, commissions, rents, and taxes in 1982 resulted in a total impact of nearly $18 million on the state economy. Further positive benefits were derived from other operating expenditures, investments, and benefit payments. Finally, our products provide protection, security, and flexibility to improve both personal and business financial planning and a safe convenient means for accumulating saving.

BUSINESS ECONOMICS
AUGUST 9, 1983

TAXES PAID BY METROPOLITAN LIFE
IN KANSAS
1982

PREMIUM TAXES	$347,303
STATE LICENSES & FEES	1,424
REAL ESTATE TAXES	96,631
ALL OTHER TAXES & FEES	447,146
TOTAL	$892,504

SUMMARY OF METROPOLITAN'S DISTRIBUTION OF ASSETS
APPLICABLE TO THE STATE OF KANSAS
DECEMBER 31, 1982

BONDS & STOCKS (BOOK VALUE)	
INDUSTRIAL & MISCELLANEOUS	$109,847,220
PUBLIC UTILITIES	46,138,045
RAILROADS	27,036,010
STATE & LOCAL	--
U.S. GOVERNMENT (POPULATION BASIS)	38,953,094
TOTAL BONDS & STOCKS	$221,974,369
MORTGAGE LOANS-NONFARM	158,333,990
MORTGAGE LOANS-FARM	75,138,852
REAL ESTATE	5,670,147
PARTNERSHIPS AND JOINT VENTURES	22,235,250
POLICY LOANS & PREMIUM NOTES	17,644,758
CASH	174,038
MISCELLANEOUS ASSETS (POPULATION BASIS)	70,534
GRAND TOTAL	$501,241,938

METROPOLITAN'S LIFE INSURANCE IN FORCE*

IN KANSAS

DECEMBER 31, 1982

	THOUSANDS OF POLICIES OR CERTIFICATES	AMOUNT ($ THOUSANDS)
ORDINARY	122.5	$737,416
CREDIT	1.5	49,928
INDUSTRIAL	66.1	37,185
GROUP (CERTIFICATES)#	51.2	1,601,353
TOTAL	241.3	2,425,881

* EXCLUDES REINSURANCE ASSUMED. INCLUDES TOTAL DIVIDEND ADDITIONS AND REINSURANCE CEDED.

\# EXCLUDES FEGLI, SGLI, VGLI AND RETIRED RESERVE COVERAGE, IF APPLICABLE.

ESTIMATED NUMBER OF PERSONS COVERED BY METROPOLITAN LIFE IN KANSAS

JANUARY 1, 1982

	NUMBER OF PERSONS (THOUSANDS)	PERCENT OF POPULATION
PERSONS COVERED BY ALL LINES OF LIFE & HEALTH INSURANCE & ANNUITIES	292	12.2%
PERSONS COVERED BY PERSONAL LIFE INSURANCE	165	6.9
PERSONS COVERED BY GROUP* LIFE INSURANCE	103	4.3
PERSONS COVERED BY ORDINARY LIFE INSURANCE	123	5.1

* INCLUDES FEGLI, SGLI, RETFE AND FEHBA, IF APPLICABLE, AS WELL AS GROUP EBP. WHERE COMMUTING ACROSS STATE BOUNDARIES IS COMMON, THE PERCENT OF POPULATION MAY BE SLIGHTLY OVER- OR UNDERSTATED.

METROPOLITAN LIFE'S BENEFIT PAYMENTS IN KANSAS DURING 1982

	AMOUNT ($ THOUSANDS)
TOTAL BENEFIT PAYMENTS*	$35,886
DEATH BENEFITS	10,539
PAYMENTS TO LIVING POLICYHOLDERS	25,347
MATURED ENDOWMENTS	1,081
ANNUITY BENEFITS	8,502
DISABILITY BENEFITS	385
SURRENDER BENEFITS	4,920
LIFE & ANNUITY DIVIDENDS TO POLICYHOLDERS	6,648
ACCIDENT & HEALTH BENEFITS	3,811

* EXCLUDES FEGLI BENEFIT PAYMENTS.

INSURANCE COMPANY TAX ISSUES

TEFRA

- We made some significant changes in insurance company taxes last year. The major accomplishment was closing the Modco loophole; but we also provided some substantial benefits to the life insurance industry. (If the early post-TEFRA revenue estimates are correct, these benefits may have been too substantial.)

- Many of the life insurance provisions enacted last year expire at the end of this year. The sunset date was designed to give us more time to analyze what a permanent tax structure for life insurance companies should be.

STAFF REPORT

- The Finance Committee and Joint Tax Committee staffs are working on a report on issues and options on insurance company taxation. The report should be ready for publication at the end of this month.

- I have asked them to examine the basic tax policy issues involved when considering the taxation system which should apply to any taxpayer: How do you accurately calculate income earned; are there special public policy issues which should be considered when deciding what the effective tax rate should be? This report will take into consideration the proposal developed by Congressmen Stark and Moore of the House Ways and Means Subcommittee on Select Revenue Measures, but it will not be limited to their approach.

POLICY

- Because many of the TEFRA provisions expire at the end of this year, there is some pressure to act before then.

- However, an extension of the TEFRA rules will have the impact, for budget purposes, of a $1 billion tax cut. We are aware that the revenues from the life insurance industry may be $1 billion less than anticipated when TEFRA was enacted, but there would still be a $1 billion annual reduction in revenues from this lower level if the TEFRA rules are extended without change.

- I also understand that sunset of the TEFRA rules would impact mutual insurance companies more than stock companies, but it was also the large mutual companies who benefitted most from the Modco loophole. (Metropolitan is the second largest mutual life insurance company by asset size--only Prudential is larger.) As you know, we grandfathered the tax benefits of Modco rather than letting the Government litigate the issue.

- That doesn't mean that there is no need to revise the insurance company tax rules. It certainly would be preferable to have a simpler and fairer system. But we should not be straying far from a revenue neutral revision.

- I understand that the Stark-Moore proposal is intended to raise slightly less than the original projection of revenues after expiration of the TEFRA provision at the end of this year ($4.7 billion). While it is unclear what changes will be made in subcommittee and full committee on the House side, it would not seem unfair if the revenue estimate for the new rules when finally enacted were to be nearer the most current estimates for 1984 under current law, (the '59 Act) after the expiration of the special TEFRA rules.

  *N.B. When industry people talk about the two year TEFRA rules they call them "stopgap" rules. They refer to the old rules which would go back into effect upon expiration of the TEFRA rules as the "'59 Act."

- Simplicity and at least revenue neutrality would seem to be important features of any revision of the insurance company tax provisions. If the Internal Revenue Code is as complicated after revision and even less revenue is collected, Congress would not have accomplished very much.

- I hope that the insurance industry will work with us in an effort to analyze, and revise where necessary, the insurance company tax laws in a manner that is both fair to the industry and consistent with good public policy.

- The insurance industry should remain an important part of the private economy. The capital formation and economic protection functions performed by the industry are vital to our society. But we also have an obligation to assure that life insurance companies are shouldering a fair part of the Federal tax burden.

- One factor that will be of substantial importance is to make sure that efforts to rationalize the taxation of life insurance companies do not put life insurance companies in a competitively disadvantaged position compared to other financial intermediaries. I am sensitive to the fact that life insurance companies compete, for example, with banks for qualified pension business and with property and casualty insurance companies for group accident and health business. The tax code should be neutral in any decision as to where a customer should go to obtain a similar product.

TIMING

- o During August, staff drafted legislation pursuant to the outline Stark-Moore proposal. I asked the Finance Committee staff to give technical assistance and Treasury has also provided drafting assistance. The discussion draft was released this week. However, that should not be interpreted as meaning that this proposal will be introduced in the Senate without change or that the proposal will not be carefully scrutinized or substantial changes would not be considered.

- o Congressman Stark intends to hold a subcommittee markup at the end of this month (September 27th) after the industry has had an opportunity to review the draft.

- o If there is substantial agreement in subcommittee, it is likely that a full Ways and Means Committee markup would follow shortly thereafter.

- o It is likely that Finance Committee hearings on life insurance taxes will not be held before the last half of October. That would mean that Senate action and and conference could be concluded this year, but it is not a certainty.

- o If it seems as though there is substantial agreement on most of the major issues, but that there is insufficient time to resolve the issue this year, it is possible that Chairman Rostenkowski and I would announce an intention to apply a January 1, 1984 effective date to legislation whicih could be concluded in the Spring.

FINANCE COMMITTEE HEARING ON PROPERTY AND CASUALTY INSURANCE COMPANIES

- o On June 13 the Finance Committee heard testimony on the taxation of property and casualty insurance companies. Last fall I asked GAO to study the taxation of property and casualty insurance companies. The June 13 hearing provided GAO an opportunity to provide their preliminary findings and also gave the public an opportunity to discuss the issues.

- o GAO told the Committee that the effective tax rate for a representative sample of companies was in the range of one percent, although some people may question their methodology.

- o The GAO and Treasury both suggested that the Committee review the issue of how reserves should be calculated and suggested that they should be discounted if the company does not have to pay claims until future years. (The life insurance industry calculates reserves on a discounted basis.)

- o There were several other issues discussed at the hearing, and, no doubt, investment in tax exempt obligations accounts for much of the low tax rates. We are continuing to review some of the specific tax provisions applying to property and casualty companies.

- o I expect to receive a draft of the GAO report within a month. It should be timely enough to be helpful.

- o At a minimum, if Congress is going to re-examine life insurance company taxation, it will be important to understand the property and casualty insurance industry, its relationship to the life insurance industry, and the differences in the method of taxation that applies to each.

- o I hope that we will be able to conform the life insurance and property and casualty insurance rules sufficiently so that tax consequences will be as neutral as possible when similar business is written in either type of company.

Discrimination in Insurance

- The general question faced when discussing discrimination in insurance is whether to include sex as a category in determining insurance risks and insurance prices.

- Statistically, women as a whole live longer than men. Insurance actuaries tell us that therefore a retirement plan that provides for payment of an annuity until the death of a woman costs more for that woman than for a similar plan for a man. Some employers have required women to pay that extra cost--either through higher premiums or by providing lower benefits.

- The Supreme Court decision in *Norris* simply held that if an employer offers the employee the option of receiving retirement benefits as an annuity in the form which pays a woman lower monthly benefits than a man who has made the same amount of contributions, the employer has violated Title VII of the Civil Rights Act of 1964.

- I welcomed the *Norris* decision but am still studying the implications of extending the decisions.

- Some individuals have asked whether *Norris* should be codified. This raises a number of other issues.

- First, if *Norris* is codified, we face again the issue of retroactive relief. The *Norris* decision was prospective only. The insurance industry has argued that a retroactive application of *Norris* would cost them billions of dollars.

- Another isssue to be faced would be whether to apply *Norris* to plans that are not covered by the Civil Rights Act, e.g. plans with fewer than 15 employees.

- A major issue is whether Congress should prohibit discrimination in any type of insurance on the basis of sex. This would impact all insurance, not only that provided by employers.

- For example, women under 25 pay less for car insurance than men under 25 because as a whole such women have fewer accidents. Women also pay less for term life insurance.

- Therefore, one question raised is whether a bill to prohibit sex discrimination in insurance helps or hurts women. Every organization has its own cost estimate. Some industry fact sheets say such a bill would cost women drivers under age 25 $700 million each year and that women would pay $360 million more in life insurance premiums. The National Organization for Women (NOW) on the other hand, claims that over the course of a lifetime the average woman pays $15,856 more than if insurance rates were not based on gender (presumably due to the extra costs of annuities for women).

- S. 372, which would prohibit discrimination on the basis of race, color, religion, sex or national origin, was introduced by Senator Hatfield before the Norris decision. Hearings were held on the bill, but it is still pending before the Commerce Committee.

- The companion House bill, H.R. 100 has been marked up at subcommittee level, but further action on this bill is awaiting a GAO report before proceeding further.

- S. 888 has provisions similar to S. 372 and H.R. 100 but no action has been taken on the bill.

OUTLINE OF REMARKS

METROPOLITAN INSURANCE COMPANIES

September 19, 1983

10:00 a.m. - One Madison Avenue, New York

I. The Need for a Budget Summit

A. Many of you may know that I called the First Concurrent Budget Resolution a dead cat. Very little has changed in recent weeks. In my view, the budget process will not be resurrected and the economic recovery secured until our leaders, from the President and the Congress to our State and local officials and business and civic leaders, pull together in order to safeguard the domestic economy. We cannot allow progress toward recovery to lull us into acquiescence.

B. That is why I have called for a budget summit and one where the President plays a key role. Just as Congress must put spending in order, the President must make clear his priorities on the budget. We need his leadership and his approval, because we know he can get the job done. He has done it before: all he needs is a clear sense of purpose.

C. The summit concept will have to begin with the President and with the Congress, but it should not stop there. All decision-makers in our economy, including business and labor, have a vital stake in what happens. We cannot please everybody, but only if we agree on the absolute priority of cutting the deficit in a way that advances our shared economic goals will we have a fighting chance to succeed. We cannot tax our way out of recession, and we cannot devastate the social and benefit programs that so many Americans depend on. But we can make adjustments on both sides of the ledger that boost the odds in our favor.

II. The Economy

A. Prognosis. We have to realistically assess the state of the economy and the prospects for the next few years. Recovery is well under way, and the groundwork has been laid for stable and lasting growth without renewed inflation. It is absolutely crucial that we proceed with care at this point, and not throw away the gains already made.

No one should doubt that we are making progress. The GNP for the second quarter of 1983 shows growth at a 9.2 percent rate: The greatest quarterly expansion since 1975. The index of leading economic indicators has jumped 11 months in a row. Industrial output rose 2.1 percent in April; the highest monthly rise in 8 years, 1.2 percent in May, 1.0 percent in June, and 1.8 percent in July. Economists agree we are in a broad based recovery.

1. Inflation was cut to 3.9 percent in 1982, from 12.4 percent in 1980. This is the lowest inflation rate since 1972. Consumer prices rose just 2.4 percent in the 12-month period ending July 1983, the lowest since 1966. Inflation in 1983 so far is running at annual rate of 3.2 percent. Even with an upward "blip" in producer prices, the inflation picture remains very good. Labor productivity rose 5.7 percent in the second quarter, contributing to further progress on inflation.

2. Interest rates are down. Although the prime rate is at 11 percent, it is still way down from the 21 percent that prevailed when President Reagan took office. Home mortgage rates are down since last year. Long-term rates for business loans are off about 3 points from a year ago.

3. Lower taxes with major improvements in tax equity will help buoy the recovery, both on the consumer side and on the investment side. The combined effect of the 1981 and 1982 tax bills has been to lower individual taxes over 3 years by $344 billion, as well as improve compliance and tax fairness. Lower individual rates boost personal income and restore incentive, while favorable capital cost recovery rules should spur investment.

4. Housing starts are up. At an annual rate of about 1.7 million in June and July, down slightly from May, new housing starts are the highest in 3 years.

o Sales of new one-family houses in June were at an annual rate of 638,000. While this is slightly below the May rate, it is up 73 percent from a year ago. Following a surge in the latter half of 1982, sales activity has moderated in the last 6 months.

o During the first 6 months of 1983, 326,000 houses were sold, up 68 percent from same period in 1982. About 56,000 new houses were sold in June.

B. Unemployment. The July unemployment rate fell from 10.0 percent to 9.5 percent, the largest monthly decline since December 1959. Total civilian employment now stands at 101.6 million, the highest level in our history. These figures indicate that the recovery is anything but anemic. According to Janet Norwood, Commissioner of the Bureau of Labor Statistics, the growth in employment at this point in the recovery is stronger than in any of the previous six recoveries. The number of unemployed has declined by 1.3 million since December 1982.

o High unemployment has to come down and stay down without inflationary stimulus--that is what we have failed to do in the past. Clearly there is a bipartisan consensus for more jobs. But resuming the inflationary policies of the past will not create lasting jobs, just an illusion of prosperity that leaves us worse off the next time we try to get "off the wagon."

o That means the most important thing we must do is judge carefully the degree of stimulus the economy can and should take, consistent with a firm anti-inflation policy. The Federal Reserve will play a key role, and has already shown a willingness to adjust its short-term goals based on its assessment of the economy. We will not allow the recession to continue, but we will not reinflate the economy, either.

In addition, constructive steps have been taken:

- A new Federal supplemental unemployment compensation program was passed with the 1982 tax bill, providing additional unemployment benefits to almost 3 million workers. This program will extend through September 30.

- The new Job Training Partnership Act emphasizes training for permanent employment rather than make-work jobs.

- The targeted jobs tax credit, which was extended for 2 years by the 1982 tax bill, gives employers an incentive to hire the disadvantaged--about 600,000 workers are certified under the program.

- The administration's enterprise zone legislation, which was approved by the Senate, could provide us with an experiment in private-sector job creation in depressed areas, through a combination of Federal tax incentives and State and local efforts to target an area for development with regulatory and tax relief, neighborhood participation, and capital and other improvements. House hearings have been promised.

C. The Deficit and Interest Rates.

1. All our economic difficulties are, of course, related--high interest rates and slow growth boost the deficit, and higher deficits create greater uncertainty in the business community as to our future course; will there be more inflation, or less credit available for business expansion?

2. Because of this, it makes sense first of all to chart a path that is most likely to bring stable growth without inflation. Higher growth boosts revenues and cuts unemployment costs, thereby reducing the deficit as well: already, upward revisions of growth estimates are being made in light of our economic progress and indications of further improvements.

3. Continued efforts to restrain the deficit by controlling Federal spending will give the Federal Reserve a bit more room to accommodate the potential for real growth that exists in the economy without inflationary pump-priming. But restraint in both fiscal and monetary policy is crucial if we want to maintain long-term confidence in the economic program. The reappointment of Chairman Volcker at the Federal Reserve is a good move towards maintaining public confidence.

III. The Budget Resolution

A. Conference Agreement. The conferees on the budget resolution tried hard to reach a reasonable agreement, but it is not clear that the result is the best way to reduce the deficit, or even that it will bring significant deficit reduction. Of the proposed deficit-reduction measures, 88 percent is within the jurisdiction of the Finance Committee--and 86 percent is due to proposed tax increases, not to spending restraint. The resolution proposes a $73 billion tax increase over three years, $12 billion in 1984, $15 billion in 1985, and $46 billion in 1986.

B. Real Choices. Because so much in the way of spending programs is left out-of-bounds, the real choice proposed for us is to raise taxes or accept for now the high deficits that result from our spending decisions. That is not an agreeable choice to make, particularly when the budget resolution provides a so-called "contingency fund" to allow for new spending if Congress decides it is needed--to the tune of $8.5 billion. In addition, this puts the Budget Committee in the position of determining specific spending policies, not just overall targets.

C. Implementation. One relevant question in evaluating the budget agreement is whether the votes exist to implement it. Many members who supported the resolution might not be as willing to vote for the tax increases needed to implement the conference agreement. If so, it does not help financial markets to propose a resolution that will not be acted on in any event.

D. Domestic spending. While we cannot let the burden of deficit reduction fall on benefits for lower-income Americans, we should not assume that domestic spending is untouchable. Even the budget conferees agree that, for example, Medicare is a proper source for savings. Certainly we have to acknowledge that Federal health program costs are out of control, and that changes are very much in order. (The resolution proposes about $1.7 billion in Medicare savings). If the contingency fund is included, domestic spending would be up $10 billion next year.

E. Alternatives. Even if we fail to implement the resolution, that does not mean the fight against the deficit is over. I have proposed that we try to work out a $70-$80 billion deficit reduction package, balanced between spending and revenue changes, and will try to work towards some common ground with Chairman Rostenkowski.

IV. Taxes: Third Year and Indexing

A. The President has said time and time again that he will fight to retain tax indexing, and many of us will continue to support him, even if a veto is required. Thirty-four Senate Republicans and 146 House Republicans have signed letters to that effect. The reasons are quite simple: these measures are good for the economy, they are fair, and they give long-needed real tax relief to the hard-pressed middle income American.

B. Third year. Why was the third year of the 1981 tax cuts so important? First, most economists agree that the timing of this last stage of President Reagan's individual tax program is excellent in terms of giving the economy a boost on the consumption side as we emerge from recession. This is a sharp contrast with the past, when tax changes to counter recession were too little and too late.

Equally important, the third year was needed in the interest of fairness. Only the third year gives a full measure of tax relief to working people. For taxpayers with incomes $1Ø,ØØØ or less, repeal of the third year means a tax increase averaging 13.9 percent. For those between $2Ø,ØØØ and $3Ø,ØØØ in income it means a 12 percent jump in taxes. 72 percent of the benefit goes to Americans making $5Ø,ØØØ or less.

In dollar terms, repealing the third year would have cost a taxpayer at $15,ØØØ income $112 in FY 1984; at $2Ø,ØØØ income, it would cost $2Ø3 in 1984; at $3Ø,ØØØ income, taxes would be $41Ø higher in 1984.

C. Indexing. Indexing is crucial not just because it provides tax relief, but because it insures truth in government: tax changes will have to be voted on openly and directly, rather than having Congress rely on inflation to raise revenues through the deception of bracket creep. Whatever attitude you take on the question of generating new revenues, it makes sense to keep indexing in place.

In addition, indexing is an important symbol of our commitment to fight inflation. Repealing it only generates significant revenues if you assume inflation will persist at fairly high levels. If we de-index, we send a signal that we are not committed to beating inflation--and that means bad news for financial markets, for interest rates, and for consumers and investors alike.

Finally, the tax relief provided by indexing is real and sustained. Indexing means $98 billion in tax relief between 1985 and 1988, assuming modest inflation. $78 billion of that goes to taxpayers earning under $5Ø,ØØØ. This group now pays about 66 percent of taxes, but will get 8Ø percent of the benefit--proving that indexing is a truly progressive tax reform.

A median income family of four would pay $1,ØØØ in additional taxes between 1985 and 1988 if indexing were repealed (assuming they earn $24,ØØØ in 1982). Remember that consumers are homebuyers as well, and their after-tax income is as important as interest rates in determining whether they will buy.

V. Other Tax Issues

A. Mortgage Revenue Bonds. The Finance Committee held hearings on proposals to eliminate the scheduled sunset of single-family issues at the end of this year. Some continued availability of these bonds after this year is likely at least for lower-income single family housing. I have proposed legislation to give states the option to issue tax credits for first time home buyers, rather than issue mortgage bonds. The Finance Committee just held hearings, and the Treasury has indicated support.

B. Flat Rate Tax. The idea of a flat-rate or greatly simplified tax system continues to be quite attractivce, as we see continued taxpayer frustration with the complexity of our system and with the idea that special exemptions or credits enable the well-to-do to 'game' the system in their favor. Walter Mondale has endorsed the Bradley-Gephardt so-called "Fair Tax," so at least some believe the idea has political appeal.

The issues remain difficult to resolve, because any major changes in the tax burden or in basic tax incentives mean taking from one group and giving to another--always a tough thing for Congress to do. The Bradley proposal is a careful political compromise desigined to keep the most popular deductions and roughly duplicate the present distribution of the tax burden--but it is not clear whether this less-graduated system would stay that way (particularly when it is not indexed, and liable to bracket creep). What we need to do is continue to build towards consensus on a simpler system by better-informing the public and testing their attitudes. But everyone does seem to agree that we need to move toward lower rates and a broader base--the direction marked out by the 1981 and 1982 tax bills.

VI. Trade

A. Trade deficit is too large. The size of our trade deficit (which is now projected at $60 billion or more in merchandise trade and $30 billion in current account) alone means Congress will continue to look hard for ways to reform our trade policy. The system of multilateral arrangements has been called into serious question as many believe it fails to meet our needs. Many voters and members of Congress will want to see us approach more of our trade problems on a bilateral basis. The average American simply does not understand why Japanese cars and TV's sell well here but American cigarettes, beef, baseball bats, and cosmetics cannot be sold in Japan. Remedies for this type of situation are certain to be a major focus of attention in this Congress.

B. Export issues. Unfortunately, the GATT ministerial failed to make progress on the question of foreign subsidies for agricultural exports. This will continue if pressure from Congress to resolve this situation through negotiation or for other export promotion actions like the recent wheat flour sale to Egypt. S. 822, recently passed by the Agricultural Committee, would establish several export promotion activities.

I support efforts to equalize the rules under which trade is conducted. This does not mean trade war, but does mean seeking to expand East-West trade, developing a viable substitute for DISC, utilizing Ex-Im Bank resources more adeptly, and enacting the trade reciprocity bill that the Senate approved. Fair access to markets must be a two-way street, and Congress will be under considerable pressure to see that that is so.

C. Import issues. As you know, the House passed "local content" legislation at the end of the last Congress. That is a drastic proposal and likely to be counterproductive in the long run if our goal is to increase access to markets and to gain maximum benefit from the mutual advantages of international trade. There may be other areas, however, where we might make adjustments: in considering extension of the Generalized System of Preferences, there may be an interest on the part of some members of the Finance Committee to seek some reciprocal benefits from the major GSP beneficiaries. The enactment of the President's Caribbean Basin Initiative partly reflects the fact that those countries offer U.S. exporters a potentially strong market. It may be difficult to renew the President's general authority to negotiate tariff reductions on a limited basis. It is a good sign that the Japanese have agreed to continue voluntarily to restrain their automobile imports to this market for a third year until the domestic industry has had an adequate time to get back on its feet, although the question of whether there will be negotiations for a fourth year is a matter of concern.

D. Clearly the heat is on when it comes to seeing that American producers get fair treatment under our system of international trade. If we choose our battles carefully to secure an appropriate response from our trading partners, we have an opportunity to making trade freer and fairer, to the advantage of everyone. But we must avoid the two extremes of allowing the world to think only the U.S. will play by the rules of free trade, regardless of disadvantage to our citizens; or, on the other hand, taking extreme unilateral actions that may look good politically but that, in the long run, will provoke severe reaction and deprive us of market opportunities. We need just the right amount of leverage to open more doors, not have them slammed in our face.

VII. Conclusion

The months and years ahead must not be dominated by rigid ideologies on either side--but neither can the President or the Republican leadership be expected to cast aside the principles of Government the American people so soundly endorsed in 1980. Those principles--a more restrained Government, a freer economy, greater accountability to the American people--are as valid today as they ever were, and there is no indication that the people have changed their commitment to these same principles. Guided by these principles, we will try to work together to build on the sound foundation for recovery that has already been laid.