

REMARKS OF SENATOR DOLE

BRISTOL MEYERS CRUCIAL ISSUES PROGRAM

Tuesday, March 20, 1984--8:00 a.m.--Pisces Club

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 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 foreseeable 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:

<u>FY 1985</u>	<u>FY 1986</u>	<u>FY 1987</u>	<u>FY 1988</u>
\$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:

<u>FY 1985</u>	<u>FY 1986</u>	<u>FY 1987</u>	<u>FY 1988</u>
\$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 deal with the deficit now, the problem will become worse. Current projections showing deficits holding in the range of \$200 billion probably are optimistic, as they are based upon assumption of steady economic growth through 1989. However, postwar experience suggests that the average recovery lasts only 3 years, making a recession in 1985 or 1986 likely.
- If we postpone action until 1985 and we do suffer another recession, the deficits would then hit the \$300-\$400 billion range. At that point, it may be difficult to cut the deficit without further weakening the economy. Our choices would become very difficult indeed.
- Of course, failure to reduce the deficit in 1984 makes a recession likely to come sooner, as interest rates are forced up by private credit demands clashing with Treasury borrowing needs.
- By postponing action of the deficit, we increase the risk of recession. The average increase in the unemployment rate during a postwar recession is about three points, or three million jobs. By acting to reduce the deficit, we can significantly lower the risk that three million workers will lose their jobs in 1985 and 1986.

- The rise in interest rates will depress auto sales, housing starts, and capital goods orders. It is widely recognized that sustained economic recovery will be impossible unless these key sectors are healthy.
- Alternatively, the Fed could offset the deficits' impact on interest rates by "monetizing" the debt, leading to a resurgence of inflation in 1985. If we do nothing, we will force the Fed to choose between high interest rates and recession, or inflation.
- Failure to reduce the deficits in 1984 may also depress the stock market. A key factor in determining equity and bond prices is investors' confidence that Congress and the Administration can produce a sound fiscal policy. If we send the signal that the deficit problem is secondary to politics, equity and bond prices may fall.
- The exploding cost of servicing the Federal debt will make controlling spending more difficult each year, unless the deficits are reduced soon. Each year that we add \$200 billion in new Federal debt adds about \$15 billion to the next year's interest costs.
- The economy is now on a path where more and more of its resources go just to pay off the debt. According to economist Lawrence Summers, "It's a case where the miracle of compounding (interest) works against you."
- In 1976 net interest accounted for just 7% of total outlays But if we do nothing, by 1988 the total Federal debt will be more than half of total GNP, and the net interest cost of servicing this debt will reach 14% of all spending. Each year that we do nothing, the share of Federal spending that we can control gets smaller.
- Recent studies indicate that current and prospective budget deficits may have helped to overvalue the American dollar. If the deficits are not reduced, the problem of overvaluation could become worse, weakening the competitive position of American exports and costing the U.S. jobs in such industries as steel, electronics, and agriculture.

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. Now he has worked with congressional Republicans to outline a \$150 billion package including defense savings (\$57 billion), nondefense cut (\$43

billion), and revenue increases (\$48 billion). As the President suggests, we can work 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 Finance Committee has agreed on spending and revenue options just within its jurisdiction that achieve about \$74 billion of the "downpayment" goal. To do that we are drawing on a number of proposals that have been on the table for some time, including some already in the legislative "pipeline":
 - Items included in the FY 1984 reconciliation bill, S. 2062, which awaits Senate action
 - 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
- Target. With an overall goal of \$150 billion in savings, we can achieve \$21.4 billion from revenue changes pending in S. 2062, \$3.8 billion in spending reduction from Finance Committee programs in S. 2062, \$3.1 billion from Grace Commission recommendations, \$9.6 billion in debt service savings, and the remainder from additional spending and tax changes aimed at desirable policy reforms.
- Feasibility. The key is to keep following the President's suggestion and concentrate 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 is of the essence if we are to make a beginning this year.
- Initial Finance Action. On February 23, the Finance Committee began action to reduce the deficit. So far the Committee has

agreed to changes in health care programs that save \$8.3 billion between now and 1987, over and above the provisions in S. 2062. In addition, the Committee agreed to tax reform and modest revenue raisers that generate \$48.1 billion between now and 1987, provided at least that amount of spending reduction can be achieved. The House Ways and Means Committee has also reported a \$50 billion tax bill, so we may be on our way.

Recovery--What progress have we made

Strength of recovery

- A strong recovery is on track and appears to be moderating to a pace that can be sustained in the years ahead. As an indication, look at the expansion of real gross national product. It grew by 9.7% in the second quarter of 1983, 7.9% in the third quarter, and an estimated 4.5% in the fourth quarter. By this measure, the recovery is the strongest since 1961.
- Housing starts are running at a rate of about 2.2 million units a year, and jumped 11.2 % in February.
- Industrial output in 1983 rose 6.5%, and factory utilization is up to 80.7%--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.

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 7.8% in February. Overall, this means unemployment has dropped 2.9 percentage points over the past year.
- The continued strength of the recovery shows that recent growth in employment has not just been a statistical fluke, but shows a real turnaround in the labor market. Unemployment fell 230,000 in

December, and there have been 4.9 million jobs created in the last year.

- What is more, the growth in jobs is broad-based. While manufacturing industries showed the most dramatic gains, all industries other than government and agriculture showed dramatic drops in unemployment.

HIGHLIGHTS OF FINANCE COMMITTEE DEFICIT REDUCTION DECISION (to date)

(Savings estimates are for period 1984-87)

Spending Restraint

- o Medicare Part B Premium. Slow the increase in the premium as a percent of program costs between 1985 and 1990. (\$0.9 billion)
- o Delay initial Medicare eligibility until month after an individual's 65th birthday. (\$800 million)
- o 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)
- o Physican freeze. Continue until July 1986 a freeze on physican's fees for those unwilling to accept assignment for all services to Medicare patients. (\$1.5 billion)
- o Fee schedule for lab services. Payments for clinical lab services would be held at 62 percent of prevailing charge levels through October 1987 (\$900 million)
- o 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. (\$1.0 billion)
- o Grace Commission. Improved cash management technicians (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)
- o Debt service. \$9.6 billion.

Revenue Increases

- o 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. (\$13.8 billion)
- o 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)

- o Real Estate. Depreciation rules (18 years for all structures except low income housing) and recapture rules for real property would be adjusted. (\$3.2 billion)
- o 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)
- o Distilled Spirits. Federal excise tax would be increased \$2.00 per proof gallon (\$1.0 billion)
- o 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)
- o 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)
- o 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.

ACTION TO DATE BY THE SENATE FINANCE COMMITTEE
(Preliminary estimates subject to revision)

<u>SPENDING</u>	<u>1984-87</u>		<u>1984-87</u>
<u>Reconciliation (S. 2062)</u>	3.8	<u>Reconciliation (S. 2062)</u>	21.4
Finance Committee provisions		*Tax Reform	13.8
<u>Additional Spending</u>		Tax benefit rule	0.8
<u>Reductions</u>		Tax FHLMC	0.3
*Part B Premium	0.9	Extend telephone tax	3.2
*Delay in Initial Eligibility for Medicare	.8	Freeze \$5000 expensing	1.4
Working Aged	1.1	Finance lease freeze	2.6
*Physician Freeze	1.5	Other freeze items	0.5
Hospital Market Basket	1.1	Electric funds transfer	0.5
Lab Fee	.9	Income Averaging	1.6
Medicaid Reduction	1.2	Factoring of trade receivables	1.5
Alcohol Rebate	.9	E&P, etc.	2.9
Revaluation of Assets	.3	Modification of Section 1231	0.4
Lesser of Costs of Charges	.3	Distilled Spirits Tax	1.0
Competitive Bidding/Claims	.2	Real Estate Package	3.2
Grace Commission	3.1	Repeal Dividend Reinvestment	.5
Debt Service	<u>9.6</u>	Miscellaneous Raisers	2.0
Total	25.8	Add-Ons (Revenue Loss)**	<u>-9.5</u>
		Total	48.1
		*in Administration Budget	

**Includes R&D credit extension and expansion (-2.0), 3-year jobs credit extension (-1.6), spousal IRAs (-0.9), enterprise zones (-1.3), insurance tax changes (-1.5), 12 cents volunteer mileage deduction (-0.1), repeal of 30 percent withholding on foreign portfolio investors (-0.4), increase the earned income tax credit (-0.4), mortgage bond extension/IDB package (-0.5), increased deduction for employee awards (-0.2), and other miscellaneous items.

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United States Senate

COMMITTEE ON FINANCE

WASHINGTON, D.C. 20510

RODERICK A. DEARMENT, CHIEF COUNSEL AND STAFF DIRECTOR
MICHAEL STERN, MINORITY STAFF DIRECTOR

March 19, 1984

MEMORANDUM

TO: SENATOR DOLE

FROM: ANNE MORAN

SUBJECT: BRISTOL MEYERS SPEECH

The foreign tax credit can affect U.S. tax on foreign income, but not on U.S. income. The foreign tax credit limits give some taxpayers who have excess credits (because they pay high foreign taxes) an incentive to label their income as foreign income rather than U.S. income.

The House and Senate bills limit corporate devices that artificially convert U.S. income to foreign income, create artificial foreign income, or seek to avoid the separate limitations imposed on foreign interest income.

There are two major provisions of both bills that attempt to accomplish these goals. First, if 10% or more of the gross income of a U.S. owned foreign corporation is derived from sources within the U.S., any distribution (or interest payment) made by the U.S. owned foreign corporation that is attributable to U.S. source income will be considered U.S. source income if it is received by a U.S. person. This prevents use of a foreign subsidiary to change what is essentially U.S. income paid to a U.S. person into foreign income. This provision applies only for purposes of the foreign tax credit limitation; it does not apply for purposes of rules that tax foreign persons on income not connected with a U.S. trade or business.

Another rule would prevent companies from using the special rules defining foreign source income to recharacterize as dividends interest income earned by a foreign corporation and paid to its U.S. parent. Such a scheme currently permits a company to avoid the separate foreign tax credit limitation on interest income.

There have been a number of questions about these provisions that we are examining to ensure that bona-fide operations abroad are not disrupted, while at the same time preventing artificial distortion of worldwide income.