

REMARKS OF SENATOR DOLE

AMERICAN INSURANCE ASSOCIATION

Tuesday, May 15, 1984--7:00 p.m.--L'Enfant Plaza

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 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 (\$40 billion), nondefense cut

(\$43 billion), revenue increases (\$48 billion), and debt service savings (\$18 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 Senate has adopted the Finance Committee's proposals on spending and revenue options just within its jurisdiction that achieve about \$74 billion of the "downpayment" goal. To do that we draw 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
- Target. With an overall goal of \$150 billion in savings, we can raise \$48 billion in revenue, save \$40 billion in defense, and save \$43 billion in nondefense programs, including \$24 billion in spending reduction from Finance Committee programs such as \$3.1 billion from Grace Commission recommendations, and \$9.6 billion in debt service savings. The remainder consists of additional spending changes and controls on appropriated funds.
- 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 Action. On February 23, the Finance Committee began action to reduce the deficit. The Committee bill agreed to by the Senate includes changes in health care programs that save over \$10 billion between now and 1987, the \$3.1 billion in Grace Commission savings, and \$9.6 billion in reduced debt service. In addition, the Senate agreed to tax reform and modest revenue raisers that generate about \$48 billion between now and 1987. The House has also approved a \$50 billion tax bill, so we are 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 SENATE DEFICIT REDUCTION DECISIONS

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

Spending Restraint

- Medicare Part B Premium. Stabilize the premium as a percent of program costs between 1985 and 1990. (\$1.2 billion)
- Delay initial Medicare eligibility until month after an individual's 65th birthday. (\$630 million)
- Working age. Non-working spouses age 65 to 69 could elect primary medical coverage under spouse's employer health plan rather than Medicare regardless of working spouse's age. (\$1.1 billion)
- Physician freeze. Continue until July 1986 a freeze on physician's fees for those unwilling to accept assignment for all services to Medicare patients. (\$2.8 billion)
- Fee schedule for lab services. Payments for clinical lab services would be held at 62 percent of prevailing charge levels through October 1987 (\$1.0 billion)
- Limit on hospital costs. For FY 1985 and FY 1986 increases in hospital cost payments under Medicare would be limited to one-half percent less than the hospital wage and price index increase. (\$1.1 billion)
- Grace Commission. Improved cash management techniques (e.g. faster deposits of receipts to the government), improving income verification procedures for benefit programs, and using IRS refund offsets to collect debts owed the government would be implemented. (\$3.1 billion)
- Debt service. \$9.6 billion.

Revenue Increases

- Tax reform. New rules would be applied to limit tax shelters in such areas as partnership allocation of expenses and income interest deductions on discount obligations, transactions between related parties, current deductions for future liabilities, and corporate deductions for extraordinary dividends received. (\$10.2 billion)
- Tax benefits. Where a taxpayer receives a refund or other recovery for State taxes or other situations that previously gave rise to a deduction, the tax benefit portion of the deduction would be brought back into income first. (\$800 million)

-2-

- Real Estate. Depreciation rules (20 years for all structures in FY 1984, 19 years in FY 1985, 18 years in FY 1986 and thereafter, new or used), and recapture rules for real property would be adjusted. (\$4.4 billion)
- Freeze. Expensing for small business investment would be frozen at \$5,000, the cost of used property eligible for the ITC would be frozen at \$125,000, and the foreign earned income exclusion would be frozen at \$80,000. (\$1.9 billion)
- Distilled Spirits. Federal excise tax would be increased \$2.00 per proof gallon (\$1.0 billion)
- Income Averaging. The base period for determining the income averaging threshold would be reduced to 3 years and the formula slightly modified. (\$1.6 billion)
- Earnings and Profits. The definition of earnings and profits would be modified so that it more closely reflects a corporation's economic income rather than its taxable income. This change will reduce a corporation's ability to pay tax-free dividends. (\$1.7 billion)
- Add-Ons. In addition to miscellaneous items, the Committee agreed to phase in spousal IRAs; an R&D package; foundation tax changes; extend the targeted jobs credit for 3 years; enterprise zones; increase the earned income credit; Foreign Sales Corporations; energy credit extension with credit reordering; and others.

PRELIMINARY ESTIMATES OF REVENUE AND FINANCE COMMITTEE PACKAGE

SPENDING	1984-87 Total (Savings in \$ billions)		1984-87 Total (in \$ billions)
- Reconciliation (S. 2062)		Reconciliation Tax Provisions (S. 2062)	21.4
Finance Committee provisions	3.8	Additional Revenue Items:	
Additional Spending Reductions		Tax shelter, accounting abuse, and corporate reform	10.2
*Part B Premium	0.4	Tax Federal Home Loan Mortg. Corp.	0.3
*Delay in Initial Eligibility for Medicare	0.6	Tax benefit rule	0.8
Working Aged	1.1	Alcohol and tobacco collections	0.5
*Physician Freeze	0.8	Freeze ACRS expensing, ITC for used prop. and foreign income exclusion	1.9
Hospital Market Basket	1.1	Postpone finance lease rules	2.7
Lab Fee	0.9	Extend telephone-excise tax	3.2
Medicaid Reduction	1.4	Modification of Sec. 1231	0.2
Alcohol Rebate	0.9	Factoring of trade receivables	1.4
Revaluation of Assets	0.3	Source of shipping income	0.2
Lesser of costs of charges	0.3	Recharacterization of U.S. income as foreign source income	0.3
Competitive Bidding/Claims	0.1	Trust distributions	0.7
Round Part B Payments	0.2	Income averaging modification	1.6
SNF Rates	(0.1)	Delay in ESOP	0.4
Grace Commission	3.1	Corporate preference exclusion increase	0.5
Debt Service	9.6	Increase distilled spirits tax	1.0
Total	24.5	Deferred rent on real and taxable property	1.7
		Repeal dividend reinvestment	0.4
		Installment sale recapture rule	0.2
		20-year life for structures	4.2
		Other miscellaneous revenue increase proposals	2.6
		Major Revenue Loss Provisions:	
		Spousal IRAs	-0.9
		Enterprise zones	-1.3
		R&D credit extension and expansion	-2.0
		R&D foreign source allocation	-0.2
		Targeted jobs tax credit	-1.6
		Life insurance tax change	-1.3
		Earned income tax credit	-0.4
		Mortgage revenue bond extension- 108 package	-0.6
		Grand Total	948.1

PROPERTY/CASUALTY INSURANCE TAXATION

DEFICIT REDUCTION ACT

Foreign Insurance Issues & Self-Insurance

Resourcing Rules

- Certain provisions in the deficit reduction package that change the rules governing the U.S. or foreign source of a taxpayer's income may affect the taxation of foreign insurance operations.
- The purpose of these provisions 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 contains a revision of the excise tax imposed on foreign insurers who insure U.S. risks. The proposal would impose a 4% excise tax on the insurer who ultimately bears the insurance risk.
- Some United Kingdom insurers have argued that this provision conflicts with the U.S.- U.K. tax treaty. Although Treasury has researched the issue and determined that no treaty violation exists, they are concerned about the objections from the U.K.
- However, under present law compliance is very difficult to monitor. The system provided in the Senate bill which would, in general, collect the tax when premiums are paid by the domestic insured 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 in June, 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 deducted 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.

PROPERTY/CASUALTY INSURANCE TAXATION

DEFICIT REDUCTION ACT

Foreign Insurance Issues & Self-Insurance

Resourcing Rules

- Certain provisions in the deficit reduction package that change the rules governing the U.S. or foreign source of a taxpayer's income may affect the taxation of foreign insurance operations.
- The purpose of these provisions 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 contains a revision of the excise tax imposed on foreign insurers who insure U.S. risks. The proposal would impose a 4% excise tax on the insurer who ultimately bears the insurance risk.
- Some United Kingdom insurers have argued that this provision conflicts with the U.S.- U.K. tax treaty. Although Treasury has researched the issue and determined that no treaty violation exists, they are concerned about the objections from the U.K.
- However, under present law compliance is very difficult to monitor. The system provided in the Senate bill which would, in general, collect the tax when premiums are paid by the domestic insured 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 in June, 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 deducted 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.