

REMARKS OF SENATOR DOLE

AMERICAN HORSE COUNCIL

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Why worry about the deficit--What
does it mean to the average American?

- If nothing is done to reduce deficit spending over the next five years, the total Federal debt will nearly double to over \$10,000 for every man, woman and child in America.
- At this level, by 1989 it will take one-half of all Americans' personal income tax payments just to pay the Federal Government's interest bill.
- By 1989 the annual Federal interest cost will amount to \$250 billion--about \$1,100 for every American.
- That \$1,100 per person interest cost is equal to 40% of each person's annual expenditure for food.
- Virtually all economists agree that the sustained enormous deficits that we are facing will be economically harmful.
- Many Americans will find home-buying more difficult with higher deficits. Consider a family purchasing a home at today's current interest rate, averaging about 12-1/2%, with a \$55,000 mortgage. If the deficits push interest rates up, total interest costs over the 30 year term will be \$15,500 more--and there are signs of that, with the prime rate up to 12-1/2--for each one percentage point increase.
- All Americans will directly feel the results of high deficits if they lose jobs as a result of a business slowdown resulting from a crowding out of private investment, or if they lose jobs to imported products made more competitive because of an abnormally strong dollar or if they end up paying higher prices because inflation is rekindled.

What is the Federal deficit likely to be?

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

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

Deficit downpayment in 1984

- The President took the lead to begin a deficit-reduction effort in 1984 by calling for bipartisan negotiations on a package to reduce the deficit by \$100 billion over 3 years. Then he worked with congressional Republicans to outline a \$150 billion package including defense savings (\$40 billion), nondefense cut (\$43 billion), revenue increases (\$48 billion), and debt service

savings (\$18 billion). As the President suggested, we are working with a variety of modest spending reductions, and tax reforms that raise revenue, to enact a significant deficit "downpayment" in 1984.

- Even though election-year politics makes it difficult to launch the kind of major assault on the deficit that we really need, that is no reason to do nothing. Making a noticeable dent in the deficit will make our job easier in the years ahead. Even more importantly, it will demonstrate that we can face up to the deficit problem even in an election year.
- The Senate has adopted the President's plan, including the Finance Committee's proposals on spending and revenue options that achieve about \$7 billion of the "downpayment" goal. To do that we drew on a number of proposals that have been on the table for some time, including some that were already in the legislative "pipeline":
 - Items included in the FY 1984 reconciliation bill, S. 2062
 - Treasury-endorsed proposals on tax shelters and other abuses
 - Administration -proposed spending cuts that were not followed through on last year
 - Administrative savings and other proposals made by the Grace Commission
 - Additional proposals considered in the Finance Committee last fall
 - Grace Commission recommendations (\$3.1 billion in the Finance package)
- Feasibility. We have made progress by following the President's suggestion and concentrating on relatively non-contentious items, avoiding things like the third-year tax cut and indexing, mean-tested entitlements, social security, and the like. Our effort must be bipartisan and balanced to do the job: Democrats and Republicans alike will benefit by cooperating to take swift action on the deficit.
- Time of the essence. The House has passed a deficit plan that makes deeper cuts in defense spending, and we are now conferring on the differences. Unless we finish action soon, election year politics may make it difficult to get this job done.

Recovery--What progress have we made

Strength of recovery

- A strong recovery is on track and appears to be moderating to a pace that can be sustained in the years ahead. As an indication, look at the expansion of real gross national product. It grew by 9.7% in the second quarter of 1983, 7.9% in the third quarter, and an estimated 4.5% in the fourth quarter. By this measure, the recovery is the strongest since 1961. And the economy grew at 8.8% in the first quarter of 1984.
- Housing starts are running at a rate of about 1.96 million units a year, and jumped 19% in February.
- Industrial output in 1983 rose 6.5%, and factory utilization is now up to 81.9%--the highest level in two years, and close to the normal capacity of 82%.
- The Commerce Department's survey of business plans for 1984 show that business plans to increase capital investment by 16%--this is higher than that seen at comparable points in previous postwar recoveries. And the 12% increase expected this year is the highest in 18 years.

Inflation

- The best news about this recovery is that it is noninflationary. In 1983 the producer price index rose just 0.6%--the lowest increase since 1964. The CPI for 1983 was 3.8%, the lowest since 1972. Continued moderation in producer prices indicates low inflation will continue.

Creating Jobs

- People are going back to work, and the pace of job creation has been unusually high for a postwar recovery. On January 6 the Labor Department announced the civilian unemployment rate dropped from 8.4% last November to 7.5% in May. Overall, this means unemployment has dropped 3.2 percentage points over the past year.
- The continued strength of the recovery shows that recent growth in employment has not just been a statistical fluke, but shows a real turnaround in the labor market. Unemployment fell 230,000 in December, and there have been 5.5 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.

Flat Tax/Tax Simplification

- The President has asked the Treasury Department to prepare, by the end of this year, a range of options for overhauling our tax system. As part of its review Treasury is now conducting hearings around the country to sample citizen opinion as to the virtues and flaws of our present tax system and ways to improve it in a major way.

- The Finance Committee held hearings on this subject in 1982 and found that the issue is not as simple as it might seem at first glance. When people talk about a 'flat tax' they are really talking about a variety of proposals to change the tax structure: whether by greatly reducing rates while eliminating deductions and credits, imposing a single low rate on all income, or changing the nature of what we are taxing by excluding from tax income that goes into savings or investment (the so-called 'consumption tax').

- All of these options will no doubt be seriously considered by the President and examined by the Congress. One major concern will be how to satisfy the public that a new system would really be more fair. Many proposals would significantly change the distribution of the tax burden, putting more of it on the middle class, even while cutting out the special tax breaks that only the wealthiest people now enjoy. That may be a worthwhile tradeoff, but it is one of the reasons why it is so important to get a fair sampling of public opinion before proceeding.

- We also have to keep in mind that not all of the goals of major tax reforms are necessarily compatible with one another. For example, simplicity is desirable because complicated rules and forms divert too many resources that could be put to more productive use. But sometimes complex rules and exceptions are needed to achieve an equitable result for different taxpayers, and equity is another major goal of tax reform. Further, a balance must be struck between the goal of revenue raising and the various policy goals that we have seen fit to embody in our tax laws, such as encouraging home ownership, or charitable giving, or child care, or whatever. Flat tax advocates want to focus on revenue-raising and economic efficiency alone, which is admirable--but existing tax preferences have strong constituencies too, and they will have to be reckoned with.

- Remember that we have already taken major steps towards tax reform by lowering and stabilizing tax rates and enacting measures to broaden the tax base. More of this incremental approach may be the most realistic way to go. Major tax reform is an extremely important long-range goal, and we may get there step by step if we have the patience.