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ADMINISTRATION'S FISCAL YEAR 1985 BUDGET PROPOSALS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
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THURSDAY, FEBRUARY 2, 1984

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 9:36 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Heinz, Pryor, Danforth, Roth, Baucus, Bentsen, Moynihan, and Boren.

[The press release announcing the hearing and the prepared statements of Senators Dole, Symms, Grassley, Bentsen, and Baucus follow:]

[Press release No. 84-109, January 24, 1984]

FINANCE COMMITTEE SETS HEARING ON ADMINISTRATION'S FISCAL YEAR 1985 BUDGET PROPOSALS

Chairman Robert J. Dole, announced today that the Senate Finance Committee will hold a hearing on Thursday, February 2, 1984, on the Administration's fiscal year 1985 budget. The Honorable Donald T. Regan, Secretary of the Treasury, will testify for the Administration.

In announcing the hearing, Senator Dole stated, "We look forward to receiving the President's budget requests and to working with Secretary Regan and the Administration to bring down projected budget deficits. This hearing will provide an opportunity for the Administration to present its budget options, and is an important first step in Senate consideration of the budget and of possible approaches to the problem of the Federal deficit."

The hearing will commence at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

[Press release No. 84-111, January 31, 1984]

FINANCE COMMITTEE SETS SECOND HEARING ON ADMINISTRATION'S BUDGET PROPOSALS

Chairman Robert J. Dole, announced today the Senate Finance Committee will hold a hearing on Tuesday, February 7, 1984, on the Administration's fiscal year 1985 budget. This is the second hearing on the FY 1985 budget to be held by the Committee. The Honorable Margaret Heckler, Secretary of the Department of Health and Human Services, will testify for the Administration.

In announcing the hearing, Senator Dole stated, "We look forward to further discussions on the Administration's budget and to hearing from Secretary Heckler the details of those proposals dealing with the income security programs. All aspects of Government spending must be examined if we are to truly make any progress in addressing the deficit."

The hearing will begin at 10:00 a.m. on Tuesday, February 7 in Room SD-215 of the Dirksen Senate Office Building.

STATEMENT OF SENATOR DOLE

This morning we officially begin deliberations on the Reagan administration's proposed budget for fiscal year 1985, and on setting a course this year that can lead to major reductions in the deficit over the next several years. President Reagan has made clear his view that the deficit problem is an urgent one by asking us to join together in a bipartisan effort to address the deficit with a "down payment" plan in 1984. In my view this opportunity must be seized, because we all have a common interest in a stable and secure economic future. Given the urgency of the task and the short session we expect to have in this political year, I am particularly pleased to have here this morning the Secretary of the Treasury, Don Regan, to help us get things underway. The budget he will discuss with us this morning was released only yesterday, so no one can accuse us of dragging our feet.

While this hearing begins our consideration of the fiscal year 1985 budget, I think we all appreciate that this is simply a continuation of the budget debate that preoccupied us for much of 1983. The unfortunate fact is that, despite all the legislative activity and rhetoric about the deficit, we failed to enact any legislation last year that would reduce the deficit significantly. In fact, we passed some legislation that made the problem worse: repealing interest and dividend withholding and approving a public works jobs bill, for instance. I have no desire to reopen any of those issues, but we cannot forget that some of our actions have made the deficit bottom line that much worse, and our task that much more urgent.

AVOID DEADLOCK

We must all work to avert the kind of legislative deadlock that prevented substantive action on the deficit in 1983. If everyone sets forth non-negotiable preconditions before agreeing to talk about the deficit problem, we will get nowhere fast. The dialogue has to begin right now, and work has to be completed in short order. Ideally we ought to have enacted legislation within the next six weeks that makes a sizeable dent in projected deficits—at least the $100 billion over three years that President Reagan suggested as a 'doable' down payment package.

Doable is the key word here. Last year the budget process stumbled over the issue of spending versus revenue, because the budget resolution called for a large tax increase—$73 billion over three years—but only very modest restraints on spending. There is a lesson to be learned here. Balance is essential, compromise is necessary, and no one segment of the budget is adequate to the task where the deficit is concerned. Fortunately, much of the groundwork for a doable deficit package was established last year in the process of budget negotiations.

BASIS FOR CONSENSUS

As the President also pointed out last week, there are several sources we can draw on to form the basis of a bipartisan deficit package. There are the spending cuts still pending before Congress from last year, as contained in S. 2062. There are the revenue provisions reported by the Committee and included in S. 2062, and there are further revenue measures pending in the House in H.R. 4170. In addition, the administration has proposed some spending cuts in the fiscal year 1985 budget that were not taken up by Congress in 1983, and further tax reform and loophole-closing measures. These items alone can go a long way toward generating $100 billion over three years, and there are places to look: Such as the recommendations of the Grace Commission, which will be the subject of a hearing before this committee next week.

The point is that, if we have realistic expectations, this job is well within our ability to do. In fact, it is the least we can do, given the dimensions of the deficit problem. This is the time for progress rather than partisan bickering. Deficit reduction is always painful, but so much of the groundwork has already been laid, it would be foolish to shirk the task at this point. There is no need to reinvent the wheel, and a lot of the necessary legislative legwork has already been done or is well under way.

So we should be ready to get right down to work. This Committee has been quite active in trying to find acceptable paramaters for a deficit-reduction package, and I hope we will continue to do so. Those of us who hoped for something more bold ought to be prepared to do the best we can in a political year—we owe that much to the people.

For those who are skeptical of Congress' ability to make difficult legislative decisions, particularly in an election year, this Committee can offer two powerful precedents that show what we can do. In 1982, also an election year, we began the process that led to enactment of TEFRA, a major three-year deficit reduction effort. And just last year, in considering social security reforms, we introduced legislation in January and completed legislative action before the end of March. So when the spirit is willing and the problem is urgent, we can do the job the voters elected us to do. Even in election years—even in an unusually short span of time.

So let us do it again—and we look forward to working with Secretary Regan and the administration to make significant inroads on the deficit in the weeks ahead.

STATEMENT OF SENATOR STEVE SYMMS

Good morning Mr. Secretary. I would like to welcome you to the beginning of this year round of discussions on the deficit.

This is the beginning of my fourth year on this Committee, my fourth year in the Senate, and my twelfth year in Congress. As each year passes, I have become more and more amused at everyone's professed concern about the growing size of the deficit, and yet, at the same time, their unwillingness to seriously address the root cause of that deficit—overspending.

In the past 53 years, we have had 45 Federal deficits, and uninterrupted deficits in the past 15 years. In that same period of time, Congress has increased taxes 193 times. So it is not for lack of revenue that we are experiencing budget deficits.

Federal spending as a percent of GNP has grown from 18.5 percent in 1960, to 20 percent in 1970, to 23 percent in 1980. Federal spending currently stands at 26 percent of GNP. Add to that the spending at the state and local government level and you have governments consuming almost 40 percent of GNP.

In reviewing the growth areas in the Budget, it is clear that the area of the Budget that has grown literally out of control in the past fifteen years is the entitlement program area. Any individual with a knowledge of fifth grade math can easily calculate and identify where our budget problems lie.

Now, we have Members of Congress continually telling the American people that we have deficits because of defense spending and because the American people are not paying enough taxes.

I will agree that savings can be achieved in the Defense Budget without damaging our defensive capabilities. Yet, in order to achieve those budget savings, Members of Congress would have to agree to close down all of the obsolete military bases, allow off-the-shelf buying, provide for a multi-year budget, and drastically change the military pay and retirement system. However, everytime an attempt is made to make these changes, we have the majority of Congress stating they would rather achieve budget savings by eliminating the modernization program and thereby significantly reducing our ability to defend this Nation.

What is even more unbelievable is the effort by many of my colleagues to continually berate the American taxpayer for not paying enough taxes. They try to blame the American taxpayer for the deficits which the Congress has incurred in its ongoing attempt to "buy" votes through social program spending.

At this point, Mr. Secretary, I believe that our elected representatives must decide if they believe in the ability of our economic system to provide the most benefits for the widest variety of people. Our Nation is in the process of transitioning from a Republic to a Democracy, and from a vibrant and growing capitalist economic system to a stagnant socialist economic system. Furthermore, we must determine the priorities in Government spending. Should the major focus of our Government be to provide for the defense of this Nation, or should it be to redistribute the income of those who are working and producing to those who are not.

Unfortunately, until these fundamental questions are answered, I believe that the Nation will continue to muddle through and suffer the consequences of Washington's profligate spending spree.

STATEMENT OF SENATOR CHARLES GRASSLEY

Mr. Chairman, I look forward to the comments of the distinguished Secretary of Treasury about the budget dilemma. When I was elected to the Senate, one of my first actions on the Budget committee was to vote against a budget which showed a $44 billion deficit. This year we are fighting to keep the deficits under $200 billion in the out years.

All of us must share the blame for this deplorable state of economic affairs. Not only is the current Congress to blame for failing to aggressively attack this problem, our predecessors made our task more difficult by enacting a series of popular programs, many of which are indexed to the cost of living. Prying our constituents from the benefits they've grown to expect is a difficult and unpleasant task.

Nevertheless, leaving our children a legacy of a staggering deficit is not how most of us choose to be remembered by history. I compliment the Chairman for his insistence that we examine this mounting problem. Members of both houses of Congress have committed themselves to this task, I hope the results are more fruitful than the results of prior years.

In my view, the Administration is absolutely correct in its assumption that spending must be controlled before the deficit will be reduced. In 1982, I voted for a $98 billion revenue bill which was supposed to solve the budget problem. The experience of TEFRA has confirmed my previous belief that spending control is a prerequisite to a balanced federal budget. While the Administration has been roundly criticized for not accepting additional tax increases, I think it is important to remember that they supported TEFRA as a means to reduce our billowing deficits. We should learn from experience and pursue a new direction.

As my colleagues on the Committee are aware, I have long sponsored a budget freeze. A budget freeze would hold 1984 spending at 1983 levels. With the exception of necessary adjustments to entitlement programs for new enrollees, all spending will be frozen. One of the virtues of this plan is its fairness. All categories of spending will be equally reduced. During this time of national economic emergency, it is unfair to increase certain categories of spending at the expense of others. Now is the time for mutual sacrifice.

Another budget issue which has been a consistent concern to me is method by which we project our revenue and spending level for future years. Until we receive accurate information about future outlays and receipts, it is difficult, if not impossible, to plan a budget which will be balanced. Accurate projections are essential in solving our budget problem.

To conclude, I strongly support the Administration's goal balancing the budget by cutting federal spending. However, I feel the only way to achieve this goal is to freeze federal spending at last year's level rather than enact a patchwork of spending cuts and tax increases. Before any realistic progress can be made in reducing the deficit, our methodology of projecting outlays and receipts must be improved. While funding programs at different levels is the political prerogative of the Administration in power, altering budget projections should not be included within this process.

I look forward to the testimony of the Secretary on the Administration's budget proposals. His comments will be helpful to all of us in our deliberations on the deficit.

STATEMENT BY SENATOR LLOYD BENTSEN

Reagan Administration budgets, Mr. Secretary, seem to me to have a higher mortality rate than a second lieutenant in time of war.

In 1982 the President's budget featured the first $100 billion deficit in the history of this country. Within weeks the President was campaigning around the country for a constitutional amendment that would make budgets like his illegal.

Last year the President's budget included our first $200 billion deficit. Congress insisted on using the legislative budget process to cut that back. The President didn't agree with the cuts Congress had in mind, so he abandoned the budget process entirely and declared that he would force the necessary savings by use of the veto. As we all know, that didn't save a nickel.

This year, though, some sort of a record must have been set when the President disavowed his budget before it was even released.

In his State of the Union address some days ago the President asked for another constitutional amendment to help him bring down the deficit. This one would permit him to veto individual items within a spending bill.

I don't follow that line of thinking, frankly. He's asking Congress to approve a fiscal 1985 budget with a $180 billion deficit and then he's asking for line-item veto authority so that he can go back through the budget, after Congress approves it, and cut the deficit. Why doesn't he just cut the budget before sending it to Congress?

We know that's not what he was really doing. What he was really doing—both in his line-item veto request and in his request for Congress to work with him in cutting $100 billion from the $537 billion in deficits his budget projects for the next three years—what he was really doing was walking away from his budget before it was even released.

The budgets of this Administration are becoming a joke. A bad joke. You don't seem to take the budget, or the budget process seriously.

We have the President's word, repeated over and over again, that he doesn't like deficits. But, judging by his budget reqyests, he likes spending cuts even less.

We have the President's word that he doesn't like deficits. But his budget repeatedly calls for more spending and less revenue.

We have the President's word that he doesn't like deficits. But this country has never seen the likes of the deficits produced by this Administration.

I want to ask you a serious question, Mr. Secretary, as the spokesman for an Administration that says it opposes deficits but keeps producing them.

Do you really think these large deficits are harmful to our economy and, if so, how? Do they have a harmful effect on interest rates? On inflation? On unemployment? On economic growth?

STATEMENT BY SENATOR MAX BAUCUS

Mr. Secretary, I was slightly discouraged when I heard you were scheduled to testify on Groundhog Day.

I hope it doesn't mean you intend to appear in front of the TV lights, mention deficits, and then go back downtown to the Treasury Department and hole up for 6 weeks.

With such huge deficits, we can't afford to let that happen.

As the Chairman knows, I appreciate his efforts in trying to bring deficits down.

He, Senator Long, and most members of this Committee, have been waging a lonely fight trying to convince the rest of Washington to take the deficit problem seriously.

We began drafting our bi-partisan deficit reduction package on November 1st.

That may seem like a long time ago—however, the federal deficit has increased another $49 billion since them!

In fact, the federal deficit has gone up another $4 billion just since the President gave his State of the Union address last week.

But, on the bright side, that speech included a real sign of hope.

The President said he wants to work with us to reduce the deficit.

I am encouraged by those constructive words.

In fact, I am more optimistic now than I have been in months about our prospects of enacting legislation which will reduce the deficit.

But as Shakespeare wrote, "Words pay no debts."

Rhetoric won't reduce the deficit.

It's time to roll up our sleeves and get back to work.

Mr. Chairman, in the interest of time, I would like the remainder of my statement to be inserted in the record.

I welcome the Treasury Secretary and am delighted he is finally prepared to join our effort.

While I am encouraged by the Administration's recent statements that it's willing to try to reduce the deficit, I am totally dissatisfied with the budget document it has presented to Congress.

The President's budget for fiscal year 1985 fails to come to grips with the number one problem facing our nation's economy: the size of the federal deficit.

The President's budget calls for nearly $200 billion a year in deficits as far as the eye can see. We all know it's impossible to keep borrowing this way.

If the deficits remain at this level, interest rates will soar even higher. This means there will be less credit available to business in Montana and across the country to grow and expand.

Montana's major industries—timber, copper and agriculture—will be especially hard hit if interest rates are not reduced. Consequently, we need a budget in 1985 that makes cutting deficits its number one goal.

Instead, the President's budget fuels the deficit problem by calling for a large increase in defense spending, while not spelling out any major ways to pay for the build-up.

The President is asking Congress to boost Pentagon spending authority to $305 billion in 1985, an after-inflation increase of 13 percent from 1984. And it's nearly a 100 percent increase in military spending since 1980.

At the same time, the President has offered proposals that would only raise about $8 billion in revenue. And domestic spending, including food stamps, housing and energy aid, would see further cuts.

In his State of the Union address last week, the President said we should not spend more than we take in. I agree. We need a budget that will bring government revenue and spending more in balance.

But we also need a budget that is fair and even-handed.

We can't ask the poor and elderly to make sacrifices while continuing to line the pockets of the Pentagon. A realistic budget plan to reduce the deficits will require sacrifices from all sides.

I think we need to set this budget aside and start over with a plan that will help strengthen our nation's economy, a plan that's balanced, fair, and compassionate.

So, while I am disappointed with the President's budget, I applaud his willingness to work with us to go beyond that budget and draft a more responsible one.

The CHAIRMAN. The Secretary just left a breakfast and he is on his way. So I wondered in the meantime if members have opening statements they would like to make. We might be able to do that now so when he arrives we can put him right on. Does anybody have any opening statements? I have one for the record. It's an excellent statement, which I haven't read. [Laughter.]

Anybody else have any?

Senator HEINZ. Mr. Chairman, I promise not to have one if everybody else agrees to that rule.

Senator PRYOR. I will submit mine for the record, Mr. Chairman.

The CHAIRMAN. The record will stay open for the mail for 2 weeks for inside deliveries.

Senator DANFORTH. May I ask you a question, Mr. Chairman, while we have a minute? Do you remember last fall before we adjourned that the staff was asked to work on some sort of package on the deficit. Has that been done?

The CHAIRMAN. We have been working on the package. Somebody changed the signals. The 1985 budget is different than the 1984 budget and so it eliminates the contingency tax, which eliminates other areas we were looking at like energy tax and surtax on corporate and individual income. So all that has been put to rest. And now we are looking at option B. And we don't know what option B is yet. No. Option B isn't even here. Rod DeArment is working on option B. [Laughter.]

Anybody else have something? [No response.]

Do you have hearings tomorrow on that, Jack?

Senator DANFORTH. Yes.

The CHAIRMAN. What time are those?

Senator DANFORTH. Like 9:30.

The CHAIRMAN. Mr. Secretary, we are very pleased to have you this morning. We understand the reason for your delay. The prayer breakfast is where we should have been. But we are also pleased to have Mrs. Regan here this morning, and we are pleased to have you here. We will try to be nice to your husband.

If there are any opening statements, we can allow 3 minutes to each member for an opening statement. Do you have time for us to make opening statements?

Secretary REGAN. Most assuredly, Mr. Chairman.

The CHAIRMAN. I think Senator Baucus indicated he wanted to make his to you.

We will start with the early bird rule, which will be David.

Senator PRYOR. I will submit mine for the record.

The CHAIRMAN. Max.

Senator BAUCUS. Mr. Secretary, it's always an important day when you testify before us. But I'm a little bit concerned this morning because, in addition, today is groundhog day. My concern is that you are going to come up here in the glare of the TV lights and talk about reducing deficits and then go back down to Treasury for the next 6 weeks and not do much about it.

We can't afford to let that happen. The deficit problem is too great and too pressing. You know the overall figures as well as I. In fact, probably even better.

But let me give you another figure that especially disturbs me. Since this committee began to try to reduce deficits on November 1, our total national debt has increased by $49 billion. And just since the President delivered the state of the Union address last week, it has increased by another $4 billion. So I suggest that it's time for us to finally do something about the deficit. In this regard, I'm happy that the President now is talking about a deficit reduction downpayment of $100 billion over 3 years.

But I think it's important also to heed the words of Shakespeare, who wrote that words pay no debts. I suggest, Mr. Secretary, that we get on with the business at hand in a truly bipartisan way. We all know that the American people don't like politicians playing politics. They can see it. They can smell it. They know what is going on. And so I suggest that the administration make a good faith effort to meet the Senate halfway and to meet the House and Tip O'Neill halfway because otherwise we are just wasting our time. And we are doing the country, I think, a disservice.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman.

Mr. Secretary, the Reagan administration budgets seem to have about the same mortality rate as a second lieutenant in time of war. In 1982 the President's budget featured the first $100 billion deficit. And within weeks, he was campaigning around the country for a constitutional amendment for a balanced budget that would have made that kind of a budget submittal illegal. Last year, the President submitted a budget that calls for a $200 billion deficit. And the Congress insisted on the legislative budget process to cut it. The President did not agree with those cuts so he abandoned the budget process; said he would take care of those deficits with a veto. And you and I know that didn't save 1 nickel.

This year, though, he has set some kind of a record because he abandoned his budget before it was even released. In his state of the Union message some days ago, the President asked for another constitutional amendment. One for a line-item veto. I really don't follow that line of thinking. He's asking the Congress to approve a fiscal 1985 budget with $180 billion deficit, and then he is asking for line item authority so he can go back through that budget, after Congress approves it, and cut the deficit. Why doesn't he cut the budget before sending it to the Congress?

We know what he is really doing. What he is really doing both in his line item veto request and in his request for Congress to work with him in cutting $100 billion from the $537 billion in deficits his budget projects for the next 3 years—what he is really doing is walking away from his budget before it is even released. The budgets of this administration are becoming a joke, and a bad joke.

I don't really see the budget process being taken seriously. We have the President's word time and time again that he doesn't like deficits. But by judging from his budget requests, he likes spending cuts even less. We have the President's word he doesn't like deficits, but his budget requests repeatedly call for more spending and less revenue. We have the President's word that he doesn't like deficits, but this country has never seen the likes of the deficits produced by this administration.

Mr. Secretary, I want to ask you a serious question. As a spokesman for an administration that says that it opposes deficits but keeps producing them, do you really think those enormous deficits are harmful to our economy? And if so, how? Do they have a harmful effect on interest rates, on inflation, on unemployment, on economic growth, on our trade deficit?

Thank you.

The CHAIRMAN. Does anyone on this side have an opening statement?

[No response.]

The CHAIRMAN. If not, we are pleased to hear the Secretary. As you have already observed, this is sort of a nonpartisan group. And we would be happy to have your statement. I did indicate as you came in that much of the material in the budget is sort of a resubmission. And you have been here before as has Mr. Chapoton and other representatives of Treasury, so if you could summarize perhaps what has been here before and maybe touch on the new areas, and then we could get into questions.

Secretary REGAN. Fine.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY, WASHINGTON, D.C.

Secretary REGAN. Thank you, Mr. Chairman, members of the committee. It's a pleasure to meet with you today to discuss the revenue aspects of the administration's budget for fiscal year 1985, and our plans to develop recommendations this year for fundamental changes to our income tax system to make it simpler, fairer, and more efficient in fostering economic growth.

The economy has made a strong recovery and is poised for a long period of expansion without a return to high rates of inflation. The rise last year in producer prices was the lowest in nearly 20 years. The increase in consumer prices in 1982 and 1983 were the lowest in more than a decade, yet the economy grew strongly last year and the decline last year in the rate of unemployment was larger than during any year in more than three decades. Unemployment remains too high, but is being reduced rapidly by the dynamic growth of the private sector.

It's too easily forgotten just how difficult the economic situation had become by the beginning of this decade, and how much progress has been made in a few short years. While not all indicators show improvement, the magnitude of the gains in 1983 in most key areas is striking indeed, especially when compared to 1980. During 1980, real gross national product actually fell. During 1983, it rose by 6.1 percent. Only 2 years in the last 20 have posted a larger gain. By the fourth quarter of 1983, growth had moderated to an annual rate of 4½ percent. In conjunction with the good inflation performance, this should reduce any concern that the economy is growing too fast.

During 1980, civilian unemployment fell by about 400,000 persons. During 1983, it rose by 4 million, the second largest rise during a calendar year in more than three decades.

During 1980, consumer prices rose by nearly 12½ percent. During last year, the rise was 3.8 percent. Chart 1 here shows that this is the best since 1972, when prices were artificially held down by price controls, and the best since 1967 for a year without price controls.

Now as chart 2 shows, the rise in producer prices was only six-tenths of 1 percent in 1983. That's the best in nearly 20 years.

The administration's emphasis on stimulating private sector growth and controlling inflation is paying dividends now in the form of more jobs and a rising standard of living. By the beginning of this decade, we could look back only on 15 years of steadily accelerating inflation and a declining rate of real growth. The prospects for the future were for more of the same. Now there is a genuine basis for optimism in the U.S. economic future. The strength of last year's recovery and the progress made against inflation reflects the flexibility and adaptability of our economic system, and proper policies will follow.

If the same policy direction is maintained in future years, the current recovery can be extended and a clear break made with the past. A long period of sluggish growth and rising inflation can be brought to an end.

The budget deficit. The projected budget deficit is $180.4 billion in 1985. The deficit is expected to remain at or about the same level for the next 2 years—$177 billion in 1986, $180 billion in 1987, and then decline to $152 billion in 1988, and $123 billion in 1989.

The existence of these large Federal budget deficits, both in 1985 and in the outyear projections, complicates the economic situation. It would be difficult to demonstrate that these deficits exerted any harmful effects last year or are likely to do so this year. But at some stage of the economy as it approaches capacity, we could face an unattractive choice between the crowding out of private borrowers on the monetization of the Federal deficits through increases in the money supply that would allow prices to rise.

Both alternatives must be avoided. Thus, it's extremely important that excessively high rates of growth in Federal spending be brought under control

This next chart, chart 8 of my submitted statement, shows revenues projected to remain in the upper portion of their historical range even with the 1981 cuts. Outlays are considerably higher than their historical average, as you can see up in here. Revenue is down here, the green line. Outlays, the orange line. And you can see what has been happening to them over a period.

The best way to reduce the outyear budget deficit is to cut the growth of spending. It's Government spending which diverts resources to the Government from the private sector whether financed by borrowing or by taxing. The choice between increased taxing and increased borrowing is a choice between undesirable alternatives, a choice which would not arise if Government spending were placed under effective control.

Genuine lasting reduction in the growth rate of Federal spending has been very difficult to achieve. It will be doubly difficult in an election year for reasons which hardly require extended elaboration. Nonetheless, we must make a beginning, a downpayment to show our continued determination to bring the outyear deficits down. But we must do so in a way consistent with continuing economic growth.

Mr. Chairman, the President is sincerely interested in making a deficit reduction downpayment. In his state of the Union address, he called for the bipartisan development of a downpayment deficit reduction plan to be comprised of some of the less contentious spending cuts still pending before the Congress, combined with certain measures to close tax loopholes and additional savings based on the Grace Commission report. If enacted, this downpayment could reduce the deficit by at least $100 billion over the next 3 years.

Assuming this downpayment is made, and that the Federal budget moves toward balance, and that the Federal Reserve can achieve and maintain a relatively steady and moderate rate of advance in money, the opportunity will exist for a lengthy, sustained economic expansion.

Budget receipts. Total budget receipts for fiscal 1985 are estimated to be $745 billion, an increase of $75 billion from the $670 billion estimated for 1984. Of this $75 billion, $67 billion, almost 90 percent, reflects the effects of economic growth. In 1985, income taxes paid by individuals and corporations are estimated to be $328 billion, and $76½ billion, respectively, which together—that is individual and corporate income taxes—account for 54 percent of the estimated budget receipts.

Social insurance taxes paid by employers and employees are expected to yield another $271 billion or 36 percent of the total. Excise taxes are expected to provide $38 billion or 5 percent. And the remaining $31 billion, 4 percent, are accounted for by a estate and gift taxes, customs duties, and miscellaneous receipts.

Budget receipts are projected to increase to $815 billion in 1986, and $888 billion in 1987. The composition of growth and receipts is shown in chart 9 of the submitted testimony. And I have it here, Mr. Chairman, to show you in a chart form. As you can see, the social insurance part, the yellow part, has been rising much more rapidly. There has been a growth here in the income tax, personal income tax in green here. It narrows here in 1983, and then continues on out. Currently it is about in the 10 percent area. And then all other taxes up here. The corporate is in green.

The CHAIRMAN. I think you said individual.

Secretary REGAN. Do you see how it narrows in here to about 8 or 9 percent, and then widens out again to where it goes back up to about 11 percent in the outyears.

New revenue proposals. The proposals in the administration's budget will increase receipts by about $8 billion in 1985, $11½ in 1986, and $14 in 1987, for a total of approximately $34 billion. I'd like to discuss these proposals in detail, but knowing you know most of them, I will skip over them rather rapidly.

The administration is calling for no new across the board tax increases. They are not needed; nor are they justified in light of current economic conditions. The budget does, however, call for a number of changes in the Tax Code that reflect necessary reforms, including the closing of loopholes that allow some to pay less than half of their fair share.

Tax initiatives in the President's budget fall under two broad categories. First, we are reproposing with some modification several items contained in last year's budget submission that the Congress did not enact. These include proposals to revitalize areas of economic distress, strengthen education, and control health care costs. We are also introducing new initiatives designed to reduce unintended tax benefits and improve the equity and fairness of the tax system, promote the fair treatment of families, foster research and experimentation, and respond to certain international concerns.

Let me now discuss some of these proposals. First, as we proposed last year, the administration seeks to limit the amount of employer paid health insurance premiums that may be excluded from income and social security taxes. That's the so-called health care cap.

We will reintroduce enterprise zone legislation. We will reintroduce tuition tax credits. And to help low and middle income families pay future higher education expenses of their children, we will reintroduce the education savings account.

Under new initiatives. The family initiative. To improve equity in our tax system, the President is recommending a package of proposals intended to promote the fair treatment of families in recognition of the important economic contributions made by spouses who do not work outside the home. The combined limit for contributions to individual retirement accounts or IRA's for husband and wife in such instances will be increased from $2,250 to $4,000.

In addition, alimony will be treated as compensation in determining the IRA deduction limit applicable to divorced individuals. And dependent care organizations that are nonprofit, we will be proposing that there be a restructuring of dependent child care credit for them.

In research and experimentation, we will be proposing to extend the R&E credit through 1988. And the definition of R&E will be modified to target the credit more effectively.

In order to alleviate concerns expressed by members of the General Agreement on Tariffs and Trade [GATT], concerning the President's tax deferral available to domestic-international sales corporations, the DISC's, we propose to replace that system with a new system for taxing export sales income.

And we appreciate the cooperation of the committee in scheduling timely hearings on that important legislation.

The CHAIRMAN. We have hearings tomorrow.

Secretary REGAN. Thank you.

In recognition of the sacrifice that members of the Armed Forces and employees of the U.S. Government must be prepared to make when they leave our borders, we propose to grant a tax exemption for U.S. military or civilian personnel who die as a result of injuries sustained outside the United States in a terrorist or military action. It really is tragic to think of widows of Marines killed in Lebanon paying income taxes on their husbands' past wages.

Structural tax reform proposals. Turning to the matters of structural tax reform, the administration is introducing three proposals.

The first will impose limitations on the availability of ACRS and investment tax credits on certain leases of property to Federal, State or local governments or organizations not subject to U.S. tax. That proposal, which is similar to one approved by this committee, will prevent tax shelter type transactions that receive widespread publicity, such as the recent sale and lease pact transactions entered into by certain municipalities and colleges.

The second of the structural reform proposals will replace the 25 year old two phase system of taxing life insurance companies with a single phase system, and remove ambiguity concerning certain innovative products introduced by the insurance industry.

Third, the administration supports proposals that will limit the alarming growth of private purpose tax exempt bonds. Total volume of these bonds has grown 570 percent from 1975 to 1982. The revenue loss to the Federal Government from these bonds is substantial. For example, we estimate the revenue loss from all outstanding private purpose tax exempt bonds in fiscal 1984 to be over $8 billion.

Curtailment of tax shelter accounting and corporate tax abuses. Many transactions that create unintended tax benefits frequently are the cornerstone of tax shelter schemes and, in most cases, involve what we consider misuse of partnership, accounting and corporate tax provisions of the Code. Current tax accounting provisions provide taxpayers with significant flexibility in determining the time at which they must report income and deduction items, and the amount of interest that must be charged on loans in deferred payment sales or property. So you have seen an alarming number of transactions that abuse that flexibility.

The proposals will tighten certain of the tax accounting provisions of the code in order to stop taxpayers from claiming unintended tax benefits.

And, finally, we've designed several changes to preclude sophisticated corporate taxpayers from abusing the rules relating to the taxation of corporations.

Improved tax compliance. Failure to comply fully with our tax law benefits the few at the expense of the vast majority of honest taxpayers. We must redouble our efforts to narrow the tax gap between the correct tax liability owed, and the amount taxpayers voluntarily pay. As the President indicated in his state of the Union address, it would be immoral to make those who are paying taxes pay more to compensate for those who are not paying their share. We expect that a number of the proposals that I have just outlined to curtail tax shelter accounting and corporate tax abuses will also improve tax compliance.

And, finally, Mr. Chairman, fundamental tax reform. While the new tax initiatives we are introducing are of immediate importance because they improve the equity and fairness of the present system, I'd like to turn now to the much broader issue of fundamental tax reform.

Last week in his state of the Union message, the President directed me to develop a plan of action to simplify the entire Tax Code so all taxpayers, big and small, are treated more fairly. The objectives of this plan include improved compliance and a broader tax base so that tax rates can be lowered. I will present a set of specific recommendations consistent with these objectives to the President in December 1984.

The President recognizes that the time to act is now. We no longer control the tax system. It controls us. Since 1980, we have made great strides. We, and by we I mean this administration, this committee and the entire Congress. And we have moved in the proper direction. We've recognized some of the major problems of the income tax structure we inherited and we have done something about them. High individual income tax rates were sapping incentives to work, save and invest. We cut them 23 percent across the board.

Bracket creep was taking increasing amounts of after tax real dollars from the pockets of individual taxpayers with a given real income, even in years when there were no explicit tax increases. We indexed the individual tax structure to eliminate permanently these unlegislated tax increases and to prevent government from raising more revenue simply through inflation. An antiquated and complex system of tax depreciation that was inadequate during periods of high inflation was helping to depress the rate of business expansion and modernization. We have replaced this system with a simplified accelerated cost recovery system that assures business the funds needed for capital improvement.

While these changes have halted the continuing rise in marginal tax rates and restored needed overall incentives for capital formation, major structural problems in the current income tax still remain. Therefore, this administration is committed to consider a major overhaul of our tax structure.

And I think, Mr. Chairman, at this point I will pause to take questions that you might have.

The CHAIRMAN. Thank you.

[The prepared statement of Secretary Regan follows:]

FOR RELEASE UPON DELIVERY
EXPECTED AT 9:30 A.M.
Thursday, February 2, 1984

TESTIMONY OF
THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today to discuss the revenue aspects of the Administration's Budget for Fiscal Year 1985 and our plans to develop recommendations this year for fundamental changes to our income tax system to make it simpler, fairer and more efficient in fostering economic growth.

The Outlook for the Economy

The economy has made a strong recovery and is poised for a long period of expansion without a return to high rates of inflation. However, in order to achieve this expansion fiscal policy must aim at the gradual reduction of the federal budget deficit by restraining the real growth of spending and thereby enlarging the scope for private sector activity, which is the only long-run source of growth in the tax base. Also, monetary policy must focus on the long-run control of the price level and avoid short-run swings in monetary growth which have been so destabilizing in the past.

The foundation for a sustained period of economic expansion is now in place. The rise last year in producer prices was the lowest in nearly twenty years. The increases in consumer prices in 1982 and 1983 were the lowest in more than a decade. Yet the economy grew strongly last year and the decline during the year in the rate of unemployment was larger than during any year in more than three decades. Unemployment remains too high but is being reduced rapidly by the dynamic growth of the private sector.

Economic Overview

It is too easily forgotten just how difficult the economic situation had become by the beginning of this decade and how much progress has been made in a few short years. Some key comparisons are summarized in an attached table (Table 1). In interpreting that table it should be recognized that 1980 was a year of recession and 1983 was a year of recovery. While not all indicators showed improvement, the magnitude of the gains in most key areas since 1980 is striking indeed.

- During 1980, real GNP actually fell. During 1983 it rose by 6.1 percent. Only two years in the last 20 have posted a larger gain.

- During 1980, civilian employment fell by about 400 thousand persons. During 1983 it rose by 4 million, the second largest rise during a calendar year in more than three decades.

- In 1980, money compensation per hour (wages plus fringe benefits) rose by about 10-1/2 percent but that apparent gain and more besides was chewed up by inflation. Real compensation before taxes fell by about 2-1/2 percent in 1980 and by an estimated 3 percent in terms of take-home pay. Real compensation rose by 2-1/2 percent during 1983 before tax and by more than 3 percent in terms of take-home pay. The real wage gains posted in 1982 and 1983 were the first since a narrow pre-tax increase in pre-tax real wages was recorded in 1978.

- During 1980, consumer prices rose by nearly 12-1/2 percent. During last year the rise was 3.8 percent, the best since 1972, when prices were artificially held down by price controls, and the best since 1967 for a year without price controls (Chart 1). The rise in producer prices was only 0.6 percent, the best in nearly twenty years (Chart 2).

- In 1980, the bank prime rate of interest averaged 16.7 percent and hit a peak of 21-1/2 percent by year-end. The prime rate is currently 11 percent.

The Administration's emphasis on stimulating private sector growth and controlling inflation is paying dividends now in the form of more jobs and a rising standard of living. By the beginning of this decade we could only look back on 15 years of steadily accelerating inflation and a declining rate of real growth. The prospects for the future were for more of the same. Now there is a genuine basis for optimism in the U.S. economic future.

The change for the better is clearly reflected in the performance of the U.S. stock market, up about 60 percent from mid-1982 and 80 percent from its 1980 lows. Confidence in the Administration's ability to continue restraining inflation, plus the more favorable tax treatment of income from capital and the outlook for high returns from economic growth have induced a substantial net inflow of capital from abroad into a wide range of real and financial investments in this country. This inflow from abroad has augmented the pool of national savings and eased the pressure on our financial markets.

Monetary policy has contributed greatly toward the reduction of inflation. The reduction of inflation since 1980 may very well prove to have been the decisive turning point in a move back toward relative price stability. But more needs to be done by the Federal Reserve to avoid short-term volatility of monetary growth so that economic expansion may continue to generate rising employment, rising living standards, and rising Federal revenue.

Assuming that the Federal Reserve will achieve a relatively steady and moderate rate of advance in money and that the Federal budget can gradually be moved toward balance, the opportunity will exist for a lengthy, sustained expansion. It is time now with a cyclical recovery well under way to give more attention to the long-run performance of the economy. We need to shape our policies over the longer term to reinvigorate the private sector. Some crucial steps have already been taken, primarily in the tax area. Marginal tax rates have been sharply reduced compared to what they would have become under prior law, the tax brackets have been indexed for inflation, the maximum tax rate on income has been lowered to 50 percent and the maximum rate on capital gains to 20 percent, and new depreciation rules have been installed to encourage capital spending.

All in all, those rules of the economic game relating to rewards and incentives have been rewritten to bring them more in line with the needs of a market-oriented economy, largely dependent upon private sector initiative. Similarly, the gradual drift toward greater and greater concentration of rulemaking and decisionmaking in Washington is being reversed. There have been notable successes in deregulation--of financial intermediaries, of energy prices, of trucking, and of airlines. Some of these were started by previous Administrations, but this Administration has pushed the deregulation program forward vigorously. The number of rules and regulations and the paper flow to Washington generally have been curbed in a substantial way. The year 1984 will be one of further reductions in Washington's involvement in the marketplace. The best insurance for strong, long-run economic performance is to rely increasingly on market signals, not on a stream of bureaucratic directives from Washington.

Economic Recovery in 1983

Last year demonstrated the effectiveness of the Administration's approach. The economy grew rapidly as it typically does in the first year of recovery and progress against inflation continued. As a result, the cycle of accelerating inflation that began in the mid-1960's has been interrupted. As shown in an accompanying chart (Chart 3), the rise in prices and unit labor costs was less last year than in the first year of any cyclical recovery since the upsurge in inflation began in the mid-1960's.

The rise last year in real GNP of 6 percent exceeded expectations. At the beginning of the year it was expected that real growth would be held down by the height of real interest rates which some traced to the size of the Federal budget deficit, and others to prior episodes of monetary volatility. While interest rates remained relatively high, they were down from 1981 and 1982 levels and the economy expanded vigorously. The quarterly pattern of growth in real GNP during 1982 and 1983 is shown in an accompanying chart (Chart 4).

At the beginning of 1983, the consensus of the private forecasting community was for real growth of roughly 4 percent during 1983. The Adminstration was even more cautious with a forecast of only a little over 3 percent real growth, although by mid-year we pushed our estimate up to 5-1/2 percent. The final result for the year was slightly above 6 percent. Real growth moderated to a 4-1/2 percent annual rate by the fourth quarter. In conjunction with good inflation performance, this should reduce any concern that may be felt about the economy's growing too fast.

At the beginning of last year the private consensus was that prices, as measured by the GNP deflator and the Consumer Price Index, would rise by 5 percent or a little more. The Administration shared that view. Actual performance was considerably better. The GNP deflator rose only a bit more than 4 percent during 1983. As mentioned earlier, the rise in consumer prices during the year was 3.8 percent, the best performance since 1972. The rise in producer prices was only 0.6 percent, the best in nearly 20 years (Table 2).

Last January the unemployment rate was close to 10-1/2 percent. Private forecasters projected a decline to the 10 percent range by the fourth quarter of last year. With its slower growth forecast, the Administration was also projecting an unemployment rate above 10 percent. Actual performance was, as we know, quite different. The rate for all workers, including the resident Armed Forces, hit 8.1 percent by December. The consensus economic forecast--as exemplified by the projections of the Blue Chip panel of economists at major financial institutions, business corporations, and academic research organizations--did not call for our reaching those levels of the unemployment rate by the end of 1984, let alone 1983.

The bottom line of concern to workers and employers is the behavior of real wages and productivity. Workers want real wage gains, not the wheel-spinning that is characteristic of the inflationary process. For example, between 1972 and 1982 real compensation per hour in the nonfarm business sector (wages plus fringes) did not rise at all on a pre-tax basis and actually fell after taxes despite a rise of about 130 percent in compensation expressed in money terms. For their part, employers are anxious to see gains in productivity since otherwise increases in money wages are reflected in rising prices, which the competitive situation may not permit, or come directly out of profits, which can eventually lead to business failure.

A dramatic change for the better has been taking place. As shown in an accompanying table (Table 3), both employees and employers gained in 1983. Growth in money compensation slowed but real wages rose--as they did in 1982. This contrasts sharply with a double-digit increase in money compensation in 1980 and an actual decline in real wages. Productivity gains increased in 1983 and the rise in unit labor costs was held to less than 2 percent--a far cry from unit labor cost increases in the 10 to 11 percent range in 1979 and 1980.

Despite a widespread belief at the beginning of last year that the current expansion would be stunted, the actual performance compares favorably with earlier cyclical recoveries. An accompanying chart (Chart 5), compares last year's record for some key statistics with the average of post-Korean recoveries, excluding the short-lived 1980 recovery.

- o Industrial production rose 15 percent in 1983, slightly more than the 13.5 percent gain averaged in previous recoveries.

- The composite index of leading indicators rose 16.2 percent in 1983, slightly more than the 15.5 percent averaged in previous recoveries.

- Manufacturing employment was up 5.8 percent, exceeding the 3.7 percent rise in earlier recoveries.

- Real retail sales were up 6.8 percent last year but are running a little behind the pace in earlier recoveries. Consumer confidence is at the highest level in more than a decade and the pace of consumer spending may pick up further.

Concern has also been expressed that the current expansion would be severely unbalanced because of the height of interest rates. Interest rates are higher than we would like to see them, but it seems that the downward movement of interest rates since early 1982 was more important than their levels. Consequently, the expansion during 1983 seemed to follow previous cyclical patterns fairly closely in terms of the contribution to total growth from the major sectors of the economy. An accompanying table (Table 4) shows the contributions to a typical recovery by real GNP components during the first year of cyclical recovery and the record in 1983. The only major difference between 1983 and the typical cyclical pattern was that net exports were substantially lower than in prior recoveries.

Typically, the early stages of recovery were powered by: (1) a swing in inventory investment; (2) a resurgence in home-building activity; and (3) an increase in consumer spending. All three contributed importantly to growth in 1983. Business capital spending typically contributes little to the early stages of recovery, but was stronger than normal last year, and can be expected to post a strong gain this year. The recovery should continue to be strong and become more balanced if interest rates resume their decline.

Credit Flows and Financial Markets

Interest rates were lower at the beginning of 1983 than at the beginning of 1982 and generally remained at those lower levels until about mid-year. At that time, however, rates rose somewhat and ended the year slightly higher, with most rates ending the year about 75 to 125 basis points above year earlier levels. For example, at year-end, the 3-month Treasury bill rate stood at 8.97 percent, compared with 8.02 percent at the end of 1982. The 3-month commercial paper rate, representing the cost of short-term funds for business borrowers, was 9.51 percent at the end of the year, in contrast to 8.60 percent at the close of

1982. And the rate for new Aa-rated corporate bonds ended 1983 at 12.82 percent, up 75 basis points on balance over the year. Long-term Treasury bond yields, as represented by the 20-year rate, were up about 130 basis points over the course of 1983, and municipal bond yields rose only about 20 basis points in 1983.

Some rates did decline in 1983 however. The prime rate, for example, was 11 percent at year-end, down from 11-1/2 percent at the end of 1982; and the rate for new conventional home mortgages declined from 13.62 percent to 13.48 percent over the year.

Despite the relatively small decline in interest rates during 1983, credit markets were able to absorb a heavy volume of new borrowing in the year. In the first three quarters of the year--the latest data available--domestic nonfinancial borrowings were at an annual rate of $494 billion, about $100 billion above such borrowings in 1982. (See Table 5.) Most of the increase in domestic nonfinancial borrowing in 1983 represented a sharp rise in demands by households, largely in the form of home mortgages and consumer credit, and in borrowing by the U.S. Government. As may be seen in Table 5, the funds for the 1983 rise in borrowings by domestic nonfinancial concerns came primarily through financial intermediation at commercial banks and savings institutions, both of which benefitted from very heavy inflows of funds to new deposit accounts, especially MMDA's, in the first half of the year. More fundamentally, the larger supplies of funds to credit markets in 1983 reflected the ability of an expanding economy to generate large saving flows, even though the saving rate remained relatively low in 1983. International capital flows helped meet the rising credit demands of U.S. households, firms, and the U.S. government.

An important feature of the economic expansion up to now has been what might be termed its capacity for self-financing. The financing needs of U.S. businesses and consumers have readily been met in the financial markets, despite the deficit financing demands of the U.S. Government. Improvement in the corporate financial picture has been a major contribution (Chart 6). Corporate cash flow more than covered corporate capital expenditures during the first three quarters of 1983; and, moreover, corporations sold a record volume of new stock issues. Hence, corporations were able to improve their balance sheets and increase their liquidity without making heavy net demands on the debt markets. International capital flows have also helped meet the rising credit demands of households and governments and the increased investment demand of the business sector.

The health of business balance sheets has been one reason why those people who said large Federal deficits inevitably meant "crowding out" have been proven wrong. Those are the people who failed to recognize that the type of changes we have instituted in the tax laws--shortened depreciation lives, liberalized tax credits, lowered capital gains taxes, and reduced marginal tax rates--crowd in business profits. That situation may gradually change as corporate credit demands increase, but the 1983 experience should stand as an object lesson to those who view Federal deficits as a growing charge against a fixed amount of savings. In a dynamic, growing economy, the pool of savings is constantly being enlarged.

The Economic Outlook

The strength of last year's recovery and the progress made against inflation reflects the flexibility and adaptability of our economic system when proper policies are followed. The foundation for further expansion is securely in place. If the same policy direction is maintained in future years, the current recovery can be extended and a clear break can be made with the past. The long period of sluggish growth and rising inflation can be brought to an end.

The outlook for 1984 is very encouraging. The broad outlines of our economic projections can be summarized briefly.

- Real GNP is projected to grow 4-1/2 percent between the fourth quarter of 1983 and the fourth quarter of 1984. That happens to be much the same real growth rate being carried in the Blue Chip consensus. Some modest slowdown in growth is normal in the second year of cyclical expansions. The average rise of 6.8 percent in the first year of five previous expansions--excluding the Korean War period and the short-lived 1980 recovery--was followed by an average 3.8 percent advance in the second year. An economy as complex as our does not run to a rigid cyclical timetable, but all things considered real growth in the 4-1/2 percent range over the four quarters of this year would appear to be a plausible outcome, assuming no international or monetary shocks.

- Inflation as measured by the GNP deflator is expected to edge up a little and a rise of 5 percent is predicted during 1984, roughly a percentage point above this year's result. Some favorable factors, particularly in the food and energy areas, may not be present to the same degree in 1984 that they were this year. There are no signs, however, of any new outbreaks of inflation. Productivity is rising and wage increases have moderated. While these factors are important, over any protracted period of time the key determinant of inflation is the rate of growth in money. If the Federal Reserve maintains a steady, moderate rate of growth in money, the recent good record of inflation can be extended.

- The rate of unemployment is projected to decline further in 1984. The forecast shows the unemployment rate at 7.7 percent by the fourth quarter of the year. It is crucially important to keep the unemployment rate declining. High rates of unemployment impose heavy costs on the individuals and families involved.

The composition of this year's gain in real output will probably change somewhat. The first year of an expansion typically receives a large boost from inventory investment. During 1983 inventory investment accounted for about two-fifths of the total rise in real GNP and a more modest contribution is likely this year. Residential construction is also unlikely to post gains on anything approaching last year's scale and may be relatively flat as is typical of the second year of expansion. On the other hand, business capital spending is gaining momentum and should make a strong contribution to growth in 1984. Net exports have been a large negative influence in recent quarters but should be less of a drag during the course of the year. State and local governments have moved into surplus and their expenditures may begin to grow a bit more rapidly. Growth in Federal outlays, on the other hand, will be under continuing downward pressure in view of the size of the deficit although the pattern of Commodity Credit Corporation outlays can sometimes obscure the underlying picture for short periods of time. The consumer, the driving force behind any strong economy, has benefitted from real wage gains and rising employment in addition to reduced marginal tax rates. High levels of consumer confidence and a reduced consumer debt burden suggest that the consumer sector will continue to be strong during 1984.

It must be obvious to all of us that economic forecasting is an uncertain art. There is always the potential for surprise. One can always draw up a list of things that could go wrong. In the present situation it might include such familiar items as: monetary slowdown and recession, an unexpected surge in budget deficits and crowding out or some international financial shock with domestic effects. These are not possibilities that can be dismissed out of hand and they surely do not constitute a barrier to continued expansion as long as policy reactions are sensible. Certainly, 1984 can be a very good year for the economy.

The Budget Deficit

The projected budget deficit is $180.4 billion in 1985. The deficit is expected to remain at about the same level for the next two years -- $177.1 billion in 1986 and $180.5 billion in 1987 -- and then decline to $152.0 billion in 1988 and $123.4 billion in 1989. Chart 7 shows the rise in the deficit in the recent recession and the projected decline, as a percentage of GNP, through 1989. This is major progress, but we can and must do better.

The existence of these large Federal budget deficits both in 1985 and in the out-year projections complicates the economic situation. It would be difficult to demonstrate that these deficits exerted any very harmful effects last year, or are likely to do so this year. This is because about $100 billion of the $200 billion Federal budget deficit is due to the lingering effects of the recession. That portion is not a cause for lasting concern. But, large so-called structural deficits that exist after full economic recovery are potentially harmful as the economy approaches full utilization of its real and financial resources.

When private demands for credit are also high and rising, there could be an unattractive choice between the crowding out of private borrowers on a sizable scale or the monetization of Federal deficits through increases in the supply of money that would allow prices to rise. Both alternatives must be avoided. Thus, it is extremely important that excessively high rates of growth in Federal spending be brought under control. Outlays (including off-budget spending) were 19.8 percent of GNP during the 10-year period of 1964-1974. During the five-year period ending in 1979 outlays averaged 22.1 percent of GNP. Since 1979 the upward trend has continued unabated: 22.9 percent in 1980, 23.5 percent in 1981, 24.4 percent in 1982, and 25.1 percent in 1983, the fiscal year ended last September.

The best way to reduce the out-year budget deficit is to cut the growth of spending. It is government spending which diverts resources to the government from the private sector, whether financed by borrowing or by taxing. The choice between taxing and borrowing is a choice between undesirable alternatives, a choice which would not arise if government spending were placed under effective control.

As Chart 8 shows, revenues are projected to remain in the upper portion of their historical range of 18 to 20 percent of GNP in spite of the tax cuts. It is the outlay side that is considerably higher than its historical average. Consequently, the Administration hopes to reduce the deficit primarily from the spending side.

Genuine lasting reduction in the growth rate of Federal spending has been very difficult to achieve. It will be doubly difficult in an election year for reasons which hardly require extended elaboration. Nonetheless we must make a beginning, a downpayment to show our continued determination to bring the out-year deficits down. But we must do so in a way consistent with continuing economic growth.

The President is sincerely interested in making a downpayment. That is why he called in his State of the Union address for the bipartisan development of a downpayment deficit reduction plan. This should be comprised of some of the less contentious spending cuts still pending before the Congress, combined with certain measures to close tax loopholes and additional outlay savings based on the Grace Commission Report. If enacted, this downpayment could reduce the deficit by at least $100 billion over the next 3 years.

Assuming this downpayment is made, and that the Federal budget moves toward balance, and that the Federal Reserve can achieve and maintain a relatively steady and moderate rate of advance in money, the opportunity will exist for a lengthy sustained economic expansion.

Budget Receipts

Total budget receipts in 1985 are estimated to be $745.1 billion, an increase of $75.1 billion from the $670.1 billion estimated for 1984. Of this $75.1 billion, $67.3 billion, almost 90 percent, reflects the effects of economic growth.

In 1985, income taxes paid by individuals and corporations are estimated to be $328.4 billion and $76.5 billion, respectively, and together account for 54.3 percent of estimated budget receipts. Social insurance taxes paid by employers and employees are expected to yield another $270.7 billion, or 36.3 percent of the total; excise taxes are expected to provide $38.4 billion (5.2 percent); and the remaining $31.1 billion (4.2 percent) are accounted for by estate and gift taxes, customs duties, and miscellaneous receipts. Budget receipts are projected to increase to $814.9 billion in 1986 and $887.8 billion in 1987. The composition and growth in receipts is shown in Chart 9.

Revenue Proposals

The proposals in the Administration's budget will increase receipts by $7.9 billion in 1985, $11.6 billion in 1986, and $14.2 billion in 1987, for a total of approximately $34 billion.

The Administration is calling for no new across-the board tax increases. They are not needed, nor are they justified in light of current economic conditions. The budget does, however, call for a number of changes in the tax code that reflect necessary reform, including the closing of loopholes that allow some to pay less than their fair share of taxes.

The tax initiatives in the President's budget fall into two broad categories. First, we are reproposing, with some modifications, several items contained in last year's budget submission that Congress did not enact. These proposals are needed to revitalize areas of economic distress, strengthen education, and control health care costs. We also are introducing new initiatives designed to reduce unintended tax benefits and improve the equity and fairness of the tax system, promote the fair treatment of families, foster research and experimentation, and respond to certain international concerns.

Let me now discuss some of the details of these proposals.

Reintroduced Proposals

Health Care Cap. The Administration proposes to limit the amount of employer-paid health insurance premiums that may be excluded from income and social security taxes. This exclusion creates inequity among employees who receive compensation packages of equal value, but pay quite different amounts of income tax because they receive different amounts of employer-provided health benefits. The exclusion also has encouraged the expansion of elaborate health insurance plans as a substitute for taxable compensation. Over the years this substitution has eroded the income tax base and contributed to the rising cost of medical services. Effective January 1, 1985, the proposal will require employees to include employer-paid health insurance premiums in taxable income to the extent that they exceed $175 per month for family plans and $70 per month for single plans. Employer-paid premiums below these amounts and premiums paid under current (but not future) union contracts will continue to be excluded from taxation. This cap would not prevent purchase of adequate coverage; for example, many of the standard plans offered by employers today have total premium costs below the cap.

Our estimates indicate that only 22 percent of employees will be affected by this limitation in 1985. Not surprisingly, affected taxpayers would be concentrated in higher income levels. Whereas fewer than 10 percent of returns with adjusted gross income below $20,000 would be affected, about 40 percent of returns with AGI above $35,000 would be affected.

Enterprise Zone Legislation. This proposal is similar in all basic elements to the proposal we made last year, except for the effective dates, and very similar to the bill previously reported out of this Committee. It is designed to create a productive free-market environment in economically distressed areas by reducing taxes, government regulations, and other government burdens on economic activity. The program includes Federal tax incentives specially designed to encourage the formation of capital and the creation of jobs, with special emphasis on hiring disadvantaged workers. This is a fresh approach to promoting economic growth in inner cities. Instead of relying heavily on government grants, which often have proven inefficient and ineffective, the enterprise zone approach concentrates on freeing private enterprises to produce, create jobs, and expand.

Tuition Tax Credits. To expand opportunities for families, and to ease the burden of the double payment for those paying public school taxes and private school tuition, the Administration also is reintroducing a proposal to allow taxpayers a credit against their income taxes equal to 50 percent of tuition costs for each child in a private elementary or secondary school. The provisions of this proposal are identical to those contained in a previous Senate Finance Committee bill except that the credit will phase out at income between $40,000 and $60,000 of adjusted gross income, as we originally proposed in 1982, rather than between $40,000 and $50,000, as agreed to by this Committee. The maximum credit per child will be $100 in 1984, $200 in 1985, and $300 in 1986 and thereafter. The Administration supports the strong anti-discrimination provisions adopted by the Senate Finance Committee last year.

Education Savings Accounts. To help low- and middle-income families pay future higher education expenses of their children, taxpayers will be permitted a tax exclusion for the earnings on savings deposited in special education savings accounts. The maximum annual contribution to these accounts will be limited to $1,000 per child. This ceiling will be reduced five cents for each dollar that the taxpayer's adjusted gross income in the prior year exceeds $40,000. Thus, no deposits could be made by families with more than $60,000 of income.

Expenses may be paid out of savings held in these accounts for tuition and room and board of full-time dependent children enrolled in undergraduate degree programs in schools that do not follow a policy of racial discrimination. These expenses must be paid directly to the university or college. Savings withdrawn for any other purpose will be assessed a penalty, except for amounts withdrawn as a result of a child's death or unusual medical expenses incurred by the child.

In order to encourage families to begin saving early for a child's higher education, deposits may be placed in these special savings accounts on behalf of any dependent children under the age of 18. In no case may an account be kept open for a child over the age of 26.

New Initiatives

Family Initiatives. The President has endorsed a package of tax proposals intended to promote the fair treatment of families under the tax system. In recognition of the important economic contributions made by spouses who do not work outside the home, the combined limit for contributions to individual retirement accounts (IRA's) for a husband and wife in such instances will be increased from $2,250 to $4,000. Every married couple that files a joint return thus will be able to deduct annual IRA contributions up to the lesser of $4,000 or 100 percent of the annual compensation received by the couple. In addition, alimony will be treated as compensation in determining the IRA deduction limit applicable to divorced individuals.

Dependent care organizations play an important role in enabling individuals, especially women, to continue their careers. We are proposing that tax-exempt status be provided to any nonprofit, dependent care facility if it is operated to provide nonresidential care, substantially all of the dependent care is provided to enable individuals to be gainfully employed, and the services provided are available to the general public. The dependent care credit available to low- and middle-income taxpayers also will be increased, with the credit available to high-income taxpayers reduced. Those taxpayers with adjusted gross incomes of $60,000 or more would receive no credit.

Research and Experimentation. Industry should be encouraged to undertake research and experimentation that may lead to productivity-enhancing innovation. To enable taxpayers to plan their R&E activities with certainty that the credit will be available, the Administration proposes to extend the R&E credit through 1988. The definition of R&E will be modified to target the credit more effectively.

To maintain current incentives for R&E conducted in the United States pending further consideration, we propose to extend for two years the moratorium on the application of Treasury regulations relating to allocations of R&E to foreign source income.

Response to International Concerns. First in this category of proposals is the introduction of a withholding system with respect to taxes on gains of foreign persons on the sale of U.S. real property. This proposed withholding system will significantly increase compliance with U.S. tax law by foreign sellers of U.S. real property interests.

In order to alleviate concerns expressed by members of the General Agreement on Tariffs and Trade (GATT) concerning the present tax deferral available to domestic international sales corporations, we propose to replace that system with a new system for taxing export sales income. This new system is intended to preserve the competitiveness of U.S. exports while addressing concerns expressed by other GATT members. We appreciate the cooperation of this Committee in scheduling hearings on this important legislation for tomorrow.

Finally, in recognition of the sacrifice that members of the U.S. Armed Forces and employees of the U.S. government must be prepared to make when they leave our borders, we propose to grant a tax exemption for U.S. military or civilian personnel who die as a result of injuries sustained outside the United States in a terrorist or military action. It is tragic to think of widows of marines killed in Lebanon paying income taxes on their husbands' past wages.

TIM's. The Administration also proposes changes in the tax law necessary to accommodate Trusts for Investment in Mortgages (TIM's). These changes are expected to expand the private secondary mortgage market, attracting additional capital to support long-term mortgage lending activity.

Structural Tax Reform Proposals. The Administration is introducing proposals to reform three areas of the tax law. The first will impose limitations on the availability of ACRS and investment tax credits on certain property leased by Federal, state, or local governments or organizations not subject to U.S. tax. This proposal will prevent the tax shelter-type transactions that have received widespread publicity, such as recent transactions entered into by certain municipalities and colleges. The Committee previously has approved this provision in last year's reconciliation bill, and we are happy to restate our support.

The second of the structural reform proposals involves broad-based improvements in the taxation of life insurance companies and their products. Under this proposal a carefully worked out single-phase system will replace the 25-year old two-phase system of taxing life insurance companies. In addition, "life insurance" will be defined to remove ambiguity concerning certain innovative products that have been introduced by the insurance industry.

Third, the Administration supports proposals that will impose a number of restrictions to limit the alarming growth of private purpose tax-exempt bonds. The total volume of these bonds has grown 570 percent from 1975 through 1982. The revenue loss to the Federal government from these bonds is substantial. For example, we estimate the revenue loss from all outstanding private purpose tax exempt bonds issued in FY 1984 to be over $8 billion dollars. The limitations we propose are similar to the limitations contained in H.R. 4170, as we expect it to be amended by the Ways and Means Committee. The proposals include state-by-state annual volume limitations on industrial development bonds and student loan bonds. The proposal also denies tax-exempt status for bonds guaranteed or backed by certain Federal agencies and subjects obligations issued by Puerto Rico and U.S. Possessions to the rules presently applied to those of State and local governments.

Curtailment of Tax Shelter, Accounting, and Corporate Tax Abuses. We have identified many transactions that are designed to create unintended tax benefits. These transactions frequently are the cornerstone of tax shelter schemes and in most cases involve what we consider misuse of the partnership, accounting, and corporate tax provisions of the Code. We are proposing a number of technical amendments to curtail these transactions.

The proposals will restrict the ability that partners may have under current law to allocate partnership income in abusive transactions. In addition, existing rules that were designed to restrict tax-motivated retroactive partnership allocations will be tightened.

Current tax accounting provisions provide taxpayers with significant flexibility in determining the time at which they must report income and deduction items and the amount of interest that must be charged on loans and deferred payment sales of property. Because the tax code does not adequately address the time value of money, we have seen an alarming number of transactions that abuse this flexibility. These transactions permit taxpayers to accelerate or inflate income tax deductions (for example, by taking a current deduction for the estimated cost of expenses to be paid for in the future) and to claim inflated ACRS allowances and investment tax credits. The proposals will tighten certain of the tax accounting provisions of the Code in order to stop taxpayers from claiming unintended tax benefits.

Several proposals are designed to preclude sophisticated corporate taxpayers from abusing the rules relating to the taxation of corporate dividends, short sales, real estate investment trusts, and regulated investment companies. The rules governing the taxation of transfers of property to foreign corporations will be tightened. We also need to end abuses involving charitable contributions, tax-free exchanges of property, securities straddles, and collapsible corporations.

Miscellaneous Provisions. Finally, the Administration proposes to extend the targeted jobs tax credit and to extend the PIK program to farmers who participate in the 1984 winter wheat program.

Employee contributions to civil service retirement will be increased from 7 percent of wages and salaries to 8 percent effective October, 1984, and to 9 percent effective October, 1985. For District of Columbia employees, the D.C. Government contribution will increase correspondingly. In addition, regular Federal/State unemployment insurance coverage will be extended to railroad employment, effective January 1, 1985.

It should be noted also that the budget adopts the assumption that certain trust fund taxes will be extended even though, under current law, they are scheduled to expire. These trust fund taxes are the Superfund taxes on hazardous substances, which expire at the end of fiscal year 1985, the Airport and Airways Trust Fund taxes, which expire at the end of calendar year 1987 and the Highway Trust Fund taxes, which expire at the end of fiscal year 1988. Our estimate of budget receipts, therefore, includes the extension of these trust fund taxes as well as the tax proposals I have previously enumerated.

Improved Tax Compliance

Failure to comply fully with our tax law benefits a few at the expense of the vast majority of honest taxpayers. We must redouble our efforts to narrow the tax gap between the correct tax liability owed and the amount taxpayers voluntarily pay. As the President indicated in his State of the Union Address, it would be immoral to make those who are paying taxes pay more to compensate for those who aren't paying their share.

We expect that a number of the proposals I have just outlined to curtail tax shelter, accounting, and corporate tax abuses also will improve tax compliance. And the IRS budget we are seeking for FY 1985 includes some 1,900 new positions--$64 million in additional outlays targeted to improve document matching, increase examination efforts, particularly for unincorporated nonfarm businesses, and implement the backup withholding system in the 1983 Interest and Dividend Tax Compliance Act.

We have seen enacted since this Administration took office a number of tough measures to improve compliance. For example, while it is too early to provide specific data on the effect of the recently broadened system of backup withholding, preliminary information indicates that 7 to 10 percent of reported taxpayer identification numbers are in error. Consequently, efforts by payors to obtain accurate numbers in response to the new backup withholding provisions will facilitate improved matching by the Internal Revenue Service of information documents on dividends and interest to tax returns and thereby help narrow the tax gap. Another example is the new tip reporting system enacted in 1982. Following this change, IRS data from Form 941 tax returns show that the amount of taxable tips in the first three quarters of 1983 were more than double the amount in the first three quarters of 1982.

Fundamental Tax Reform

While the new tax initiatives we are introducing are of immediate importance because they improve the equity and fairness of the present system, I would like to turn now to the much broader issue of fundamental tax reform.

Last week, in his State of the Union Message, the President directed me to develop a plan of action to simplify the entire tax Code so all taxpayers, big and small, are treated more fairly. The objectives of this plan include improved compliance and a broader tax base so that tax rates can be lowered. I will present a set of specific recommendations, consistent with these objectives, to the President by December 1984.

The President recognizes that the time to act is now. We no longer control the tax system. It controls us.

Since 1980 we have made great strides. We, and by we I mean this Administration, this Committee, and the entire Congress, have moved in the proper direction. We have recognized some of the major problems of the income tax structure we inherited and we have done something about them.

- High individual income tax rates were sapping incentives to work, save, and invest. We cut them 23 percent across the board.

- Bracket creep was taking increasing amounts of after-tax real dollars from the pockets of individual taxpayers with a given real income, even in years when there were no explicit tax increases. We indexed the individual tax structure to eliminate permanently these unlegislated tax increases and to prevent government from raising more revenue simply through inflation.

- An antiquated and complex system of tax depreciation that was inadequate during periods of high inflation was helping to depress the rate of business expansion and modernization. We have replaced this system with a simplified accelerated cost recovery system that assures business the funds needed for capital improvement.

While these changes have halted the continuing rise in marginal tax rates and restored needed overall incentives for capital formation, major structural problems in the current income tax still remain. Therefore, this Administration is committed to consider a major overhaul of our tax structure.

Households and businesses must be allowed to make the best use of the resources at their disposal with a minimum of intrusion by tax considerations. Efficient use of resources requires a tax system that does not interfere with economic decisions in a capricious and haphazard manner. Under our present income tax structure, the size of your tax bill depends not only upon the size of your income but also upon how you earn your income and how you spend your income.

This complexity leads many households and businesses to consult tax planners before making any major decision affecting their pocketbooks. Every decision made on the basis of tax considerations rather than economic considerations is robbing us all each day.

Only with a tax system that does not discriminate among ways of earning and spending money can we achieve the highest attainable level of economic growth. We must recognize that any deviations from this standard will cause the Nation's resources to be allocated in a less than optimal fashion, resulting in lower productivity, a dampened rate of economic expansion, and in the end, a lower standard of living for all.

We already have spent a good deal of time at the Treasury Department during 1982 and 1983 examining ways to make fundamental changes in our current tax structure. We are considering a number of approaches including a consumed income tax--a broad-base tax on all sources of income with a deduction for net savings, a value-added tax, and various forms of broad-based, low-rate income taxes. At the President's direction, we will intensify our study of these and other tax alternatives over the next 11 months.

By December 1984, I expect to have for the President a set of specific recommendations for fundamental changes in our present income tax structure that will make our system of taxation much simpler, more fair, more neutral, and more efficient while fostering economic growth. If we can develop a system of taxation based on these goals, we will encourage better compliance and reduce the reward for engaging in either tax shelters or the underground economy.

For us at Treasury this will be a year of intensive study. In the course of this study we will have to deal with some very difficult issues associated with any radical transformation of the income tax structure. Some tough and unpopular decisions will be part of the price to pay for a simple, neutral, and equitable system of taxation.

I know that you, Mr. Chairman, and members of this committee recognize that this is a tall order to fill. The present Internal Revenue Code was written over a number of decades. As a result, the tax law has accumulated many patchwork provisions, often designed to meet temporary needs of particular interest groups, that have added to the complexity of the system and distorted economic choices. It is time to take a fresh look at our entire tax system. We welcome any suggestions from members of this Committee.

Chart 1

CONSUMER PRICE INDEX

(Monthly Data, Percent Change from Year Earlier)

Percent | Percent

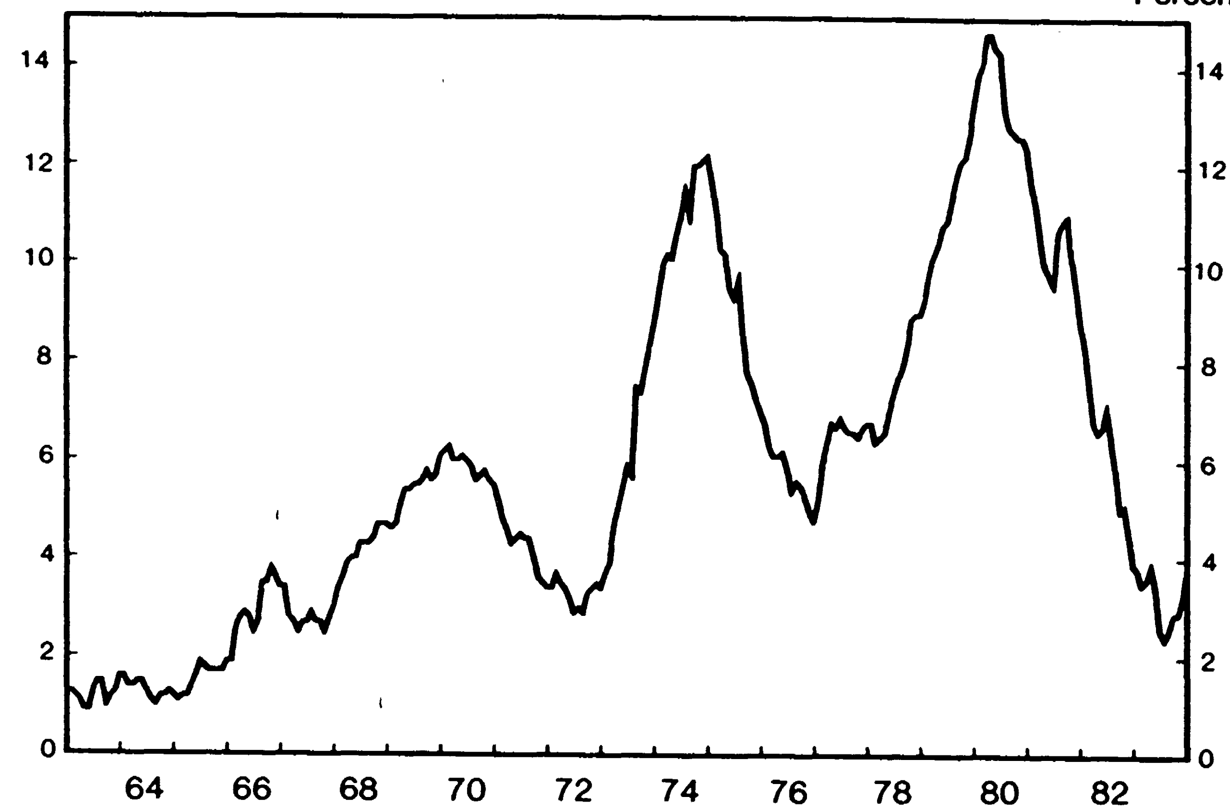


Chart 2

PRODUCER PRICE INDEX

(Monthly Data, Percent Change from Year Earlier)

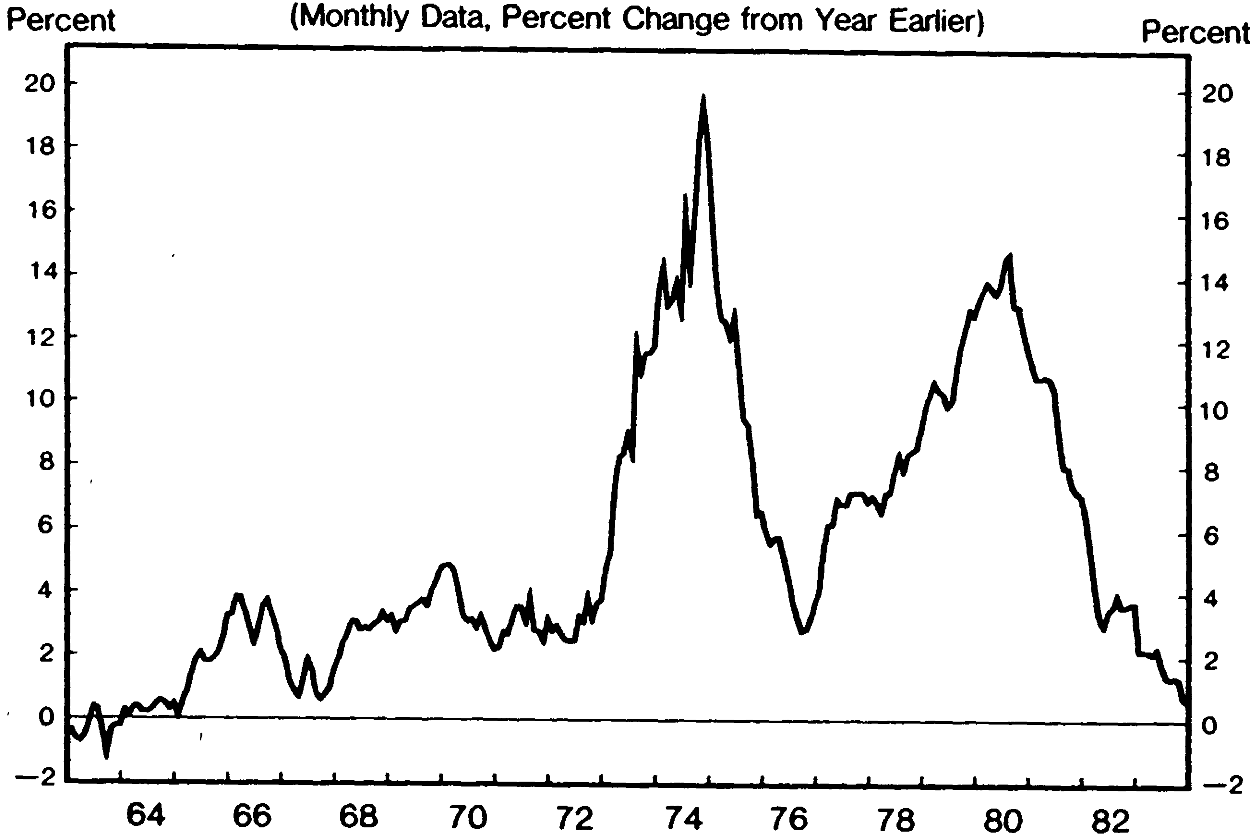
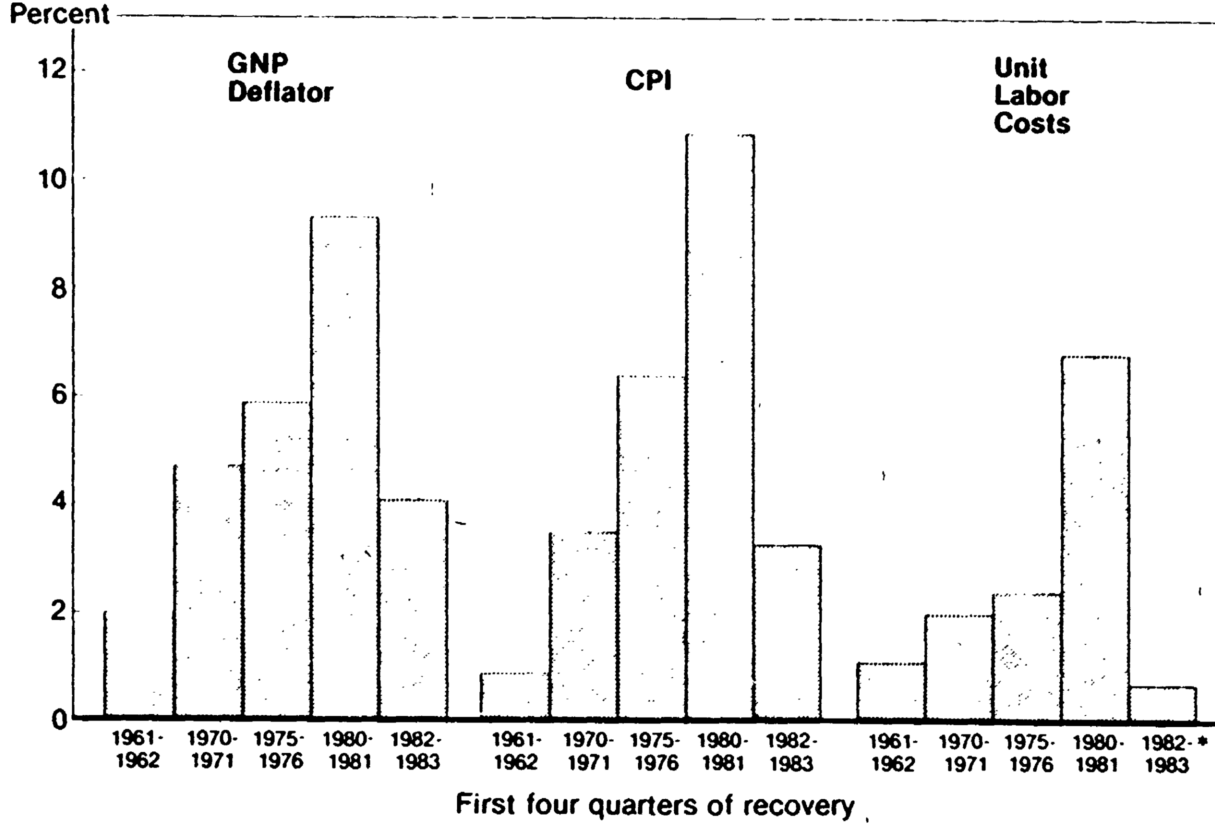


Chart 3

GROWTH OF PRICES AND UNIT LABOR COSTS IN THE FIRST YEAR OF RECENT CYCLICAL RECOVERIES



*First three quarters of the cyclical recovery.

Chart 4

RECENT CHANGES IN REAL GNP

(Percent change at annual rate)

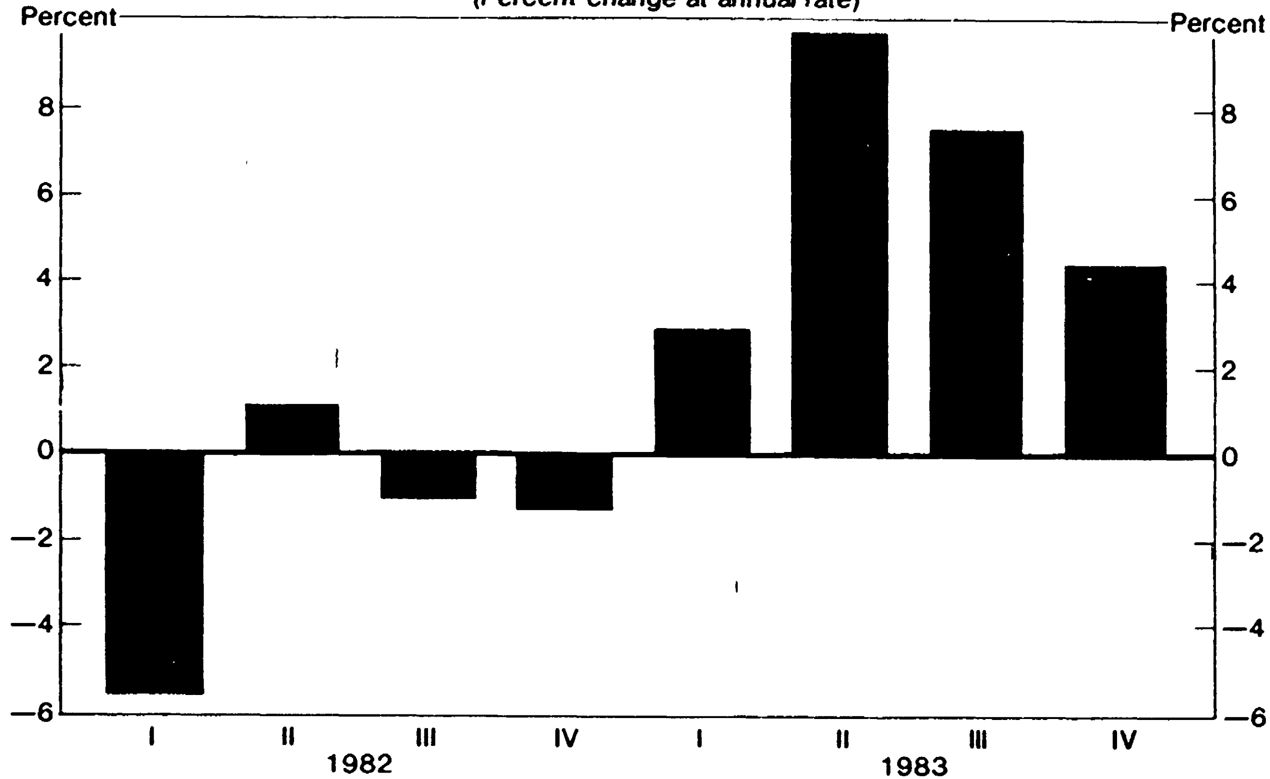


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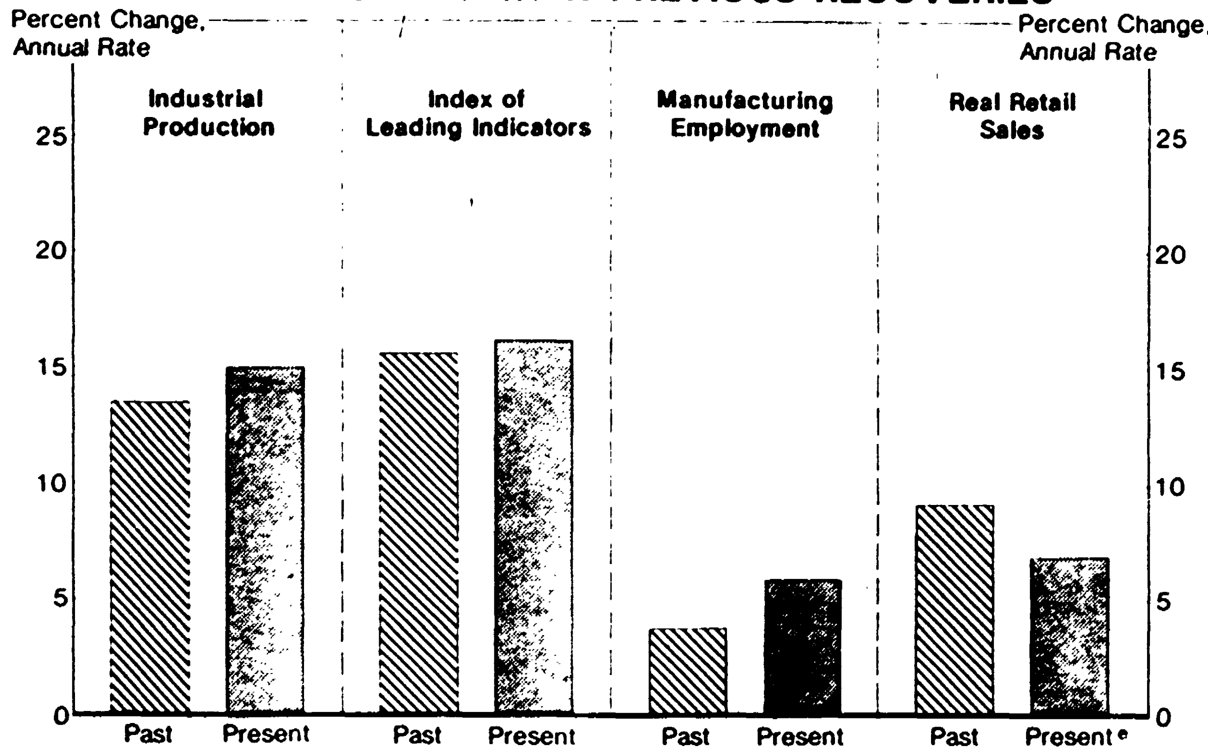
Chart 5

COMPARISON OF THIS RECOVERY WITH PREVIOUS RECOVERIES*



*Post-Korean War recoveries excluding one short-lived 1980 recovery First 13 months for industrial production and real retail sales, 12 months for the other two series

(e)-estimated

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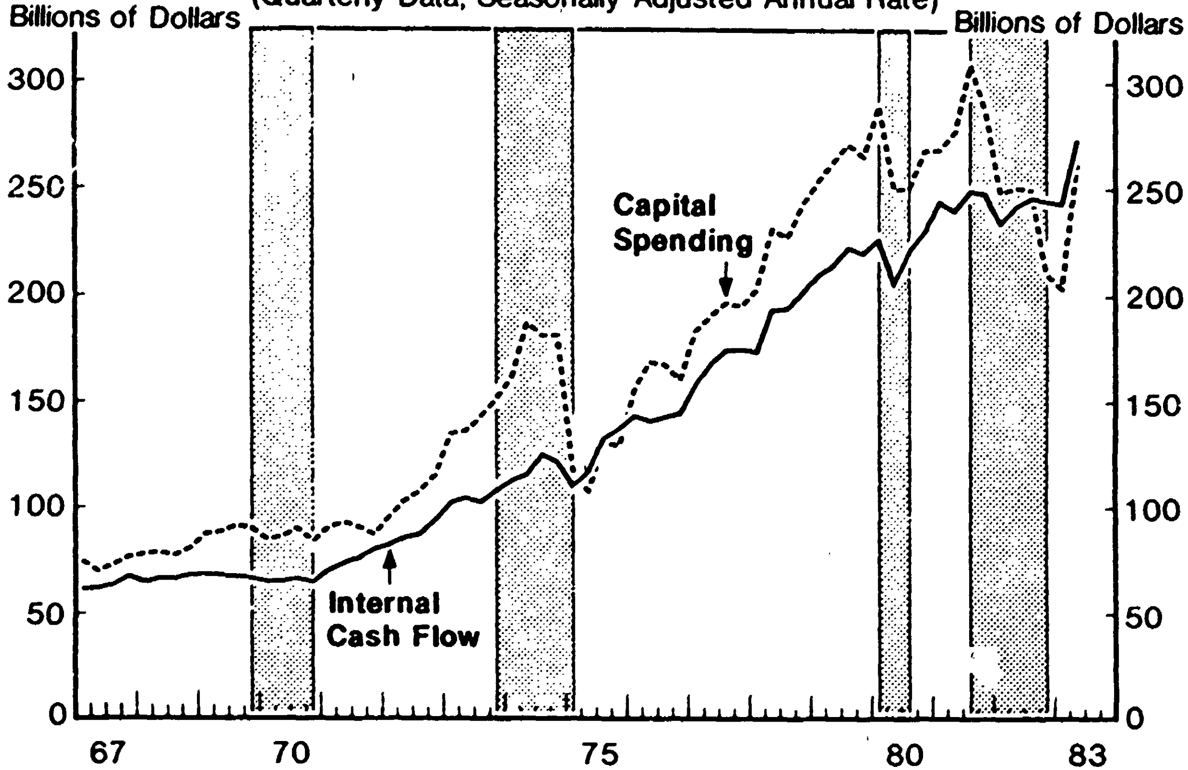
Chart 6

EXTERNAL CORPORATE FINANCING REQUIREMENTS

(Quarterly Data, Seasonally Adjusted Annual Rate)



Source: Federal Reserve flow of funds accounts.

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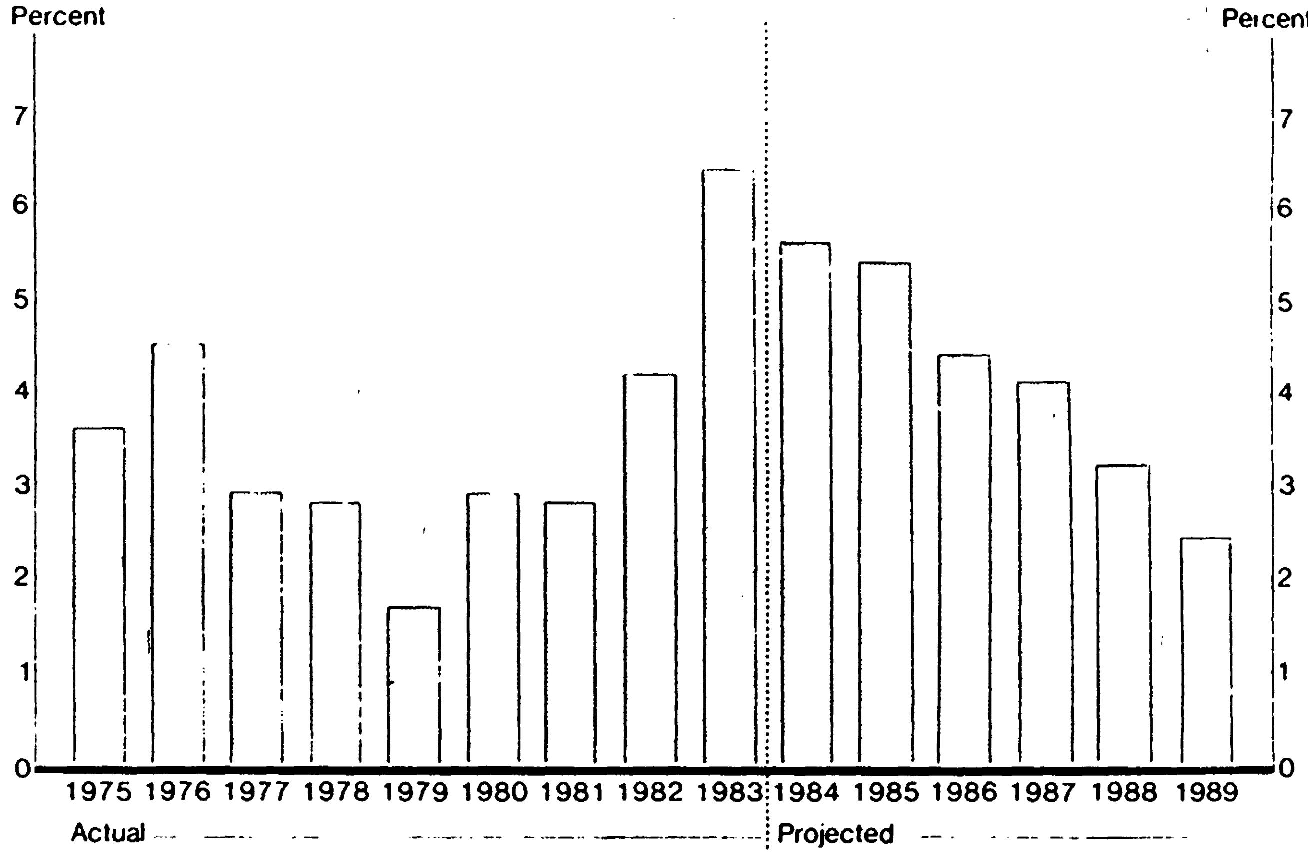
Chart 7

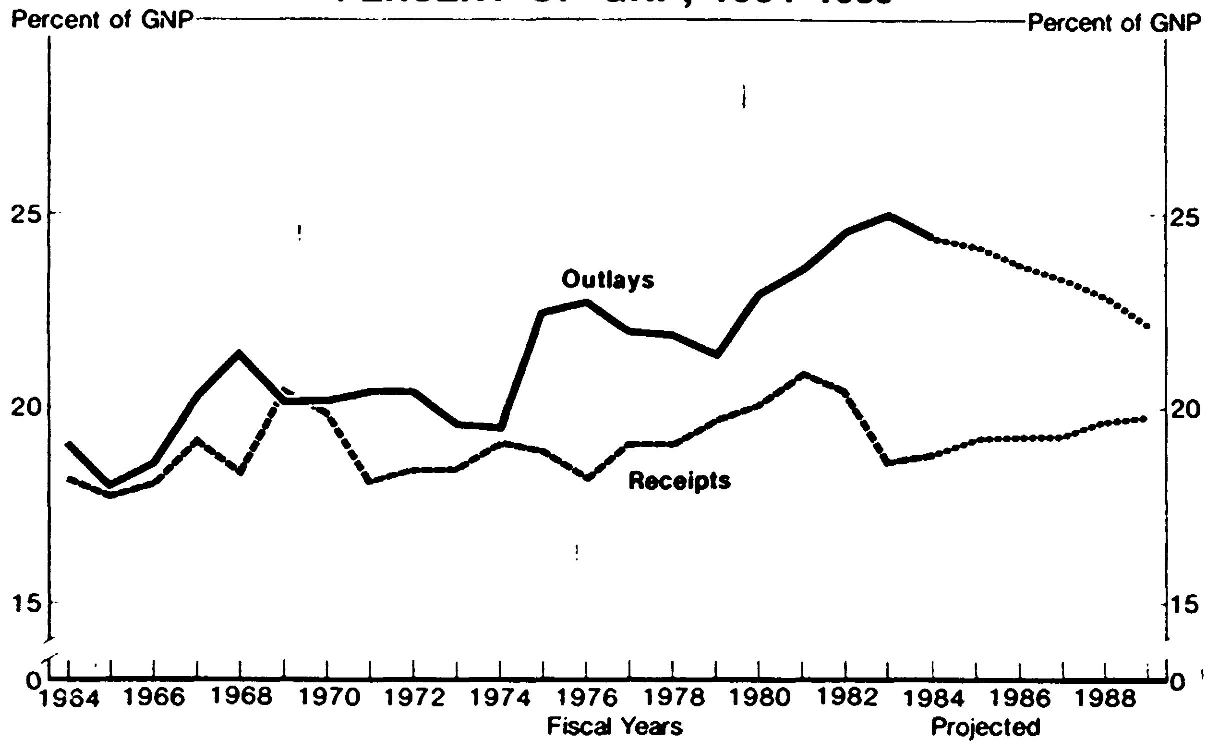
BUDGET DEFICITS IN RELATION TO GNP*



*On and off budget as percent of fiscal year GNP

Chart 8

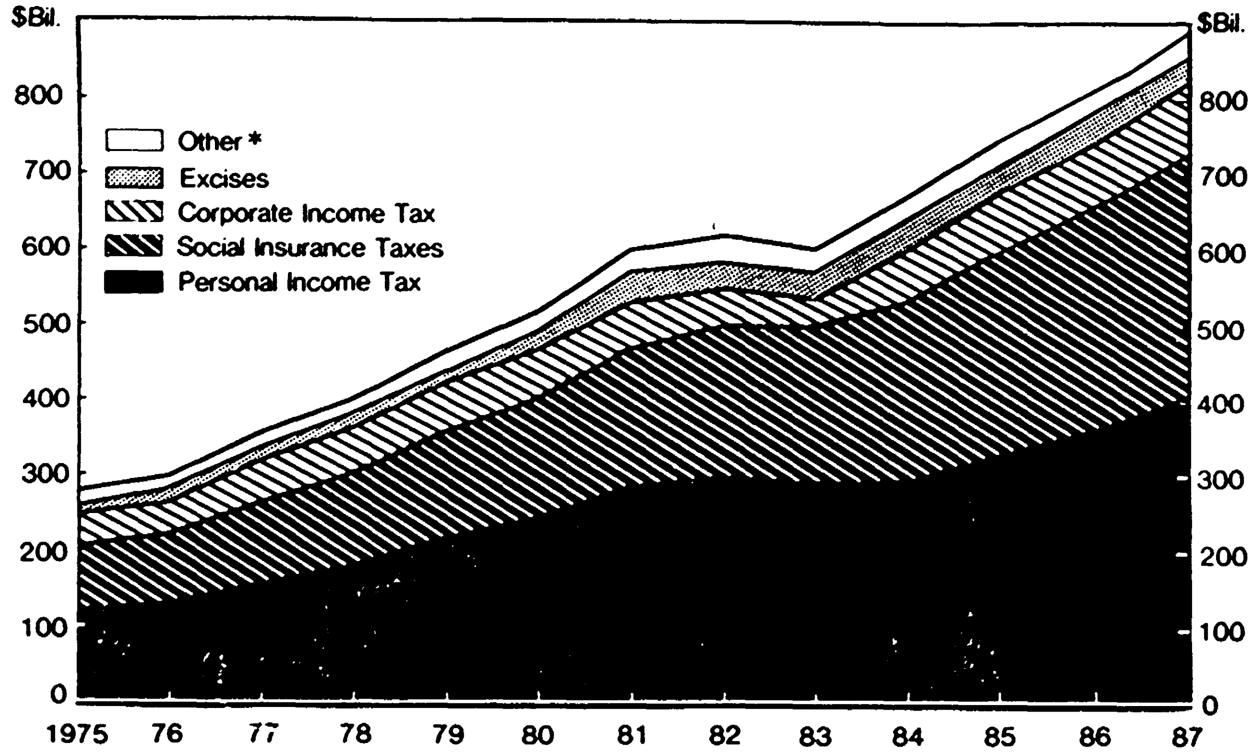
OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1989



Note. Outlays include off-budget federal entities

Chart 9

BUDGET RECEIPTS



*Other receipts include estate and gift taxes, customs duties, earnings of Federal Reserve System and other miscellaneous receipts.

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Table 1

SOME KEY COMPARISONS 1980 AND 1983

	1980	1983
Growth in real GNP (in percent)	—0.8	6.1
Growth in civilian employment (millions)	—0.3	4.0
Growth in real wages plus fringes (in percent)	—1.6	2.6*
Rise in consumer prices (in percent)	12.4	3.8
Prime rate of interest (in percent, fourth quarter)	16.7	11.0

*Real compensation per hour.
Four quarters ending in 1983-III.

Table 2

RECENT PROGRESS AGAINST INFLATION

(percent change during the year)*

	1979	1980	1981	1982	1983
GNP: Implicit Price Deflator	8.2	10.2	8.7	4.4	4.1
Consumer price index	13.3	12.4	8.9	3.9	3.8
Producer price index	12.8	11.8	7.1	3.7	0.6

* Fourth quarter to fourth quarter for the GNP deflator and December to December for consumer and producer prices.

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Table 3

COMPENSATION, PRODUCTIVITY AND UNIT LABOR COSTS, NONFARM BUSINESS SECTOR, 1979 - 1983

(percent change from fourth quarter of previous year)

	Nominal Compensation	Real Compensation	Productivity	Unit Labor Costs
1978	8.9	—0.1	0.3	8.6
1979	9.2	—3.2	—2.1	11.6
1980	10.8	—1.6	0.2	10.5
1981	9.0	—0.5	1.2	7.7
1982	7.2	2.6	0.8	6.3
1983*	5.3	2.6	3.6	1.6

* Four quarter change ending in 1983-III

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Table 4

PATTERN OF GNP GROWTH IN THE FIRST YEAR OF PREVIOUS RECOVERIES* COMPARED WITH 1983

	In Percentage Points		As Proportion of Total	
	Previous Recoveries	1983	Previous Recoveries	1983
Real GNP	6.8	6.1	——	——
Consumer spending	3.6	3.6	53	59
Business capital spending	0.5	1.2	7	20
Residential construction	1.0	1.0	15	16
State and local purchases	0.5	0.1	7	2
Federal purchases	—0.2	—0.5	—3	—8
Inventory investment	1.8	2.0	26	33
Net Exports	—0.4	—1.4	—6	—23

* Post-Korean War recoveries excluding the short-lived 1980 recovery.

Note: Components may not add because of rounding.

Table 5

FUNDS RAISED BY DOMESTIC NONFINANCIAL BORROWERS IN U. S. CREDIT MARKETS

(Billions of $)

	1982	1983*
Private Domestic Nonfinancial	234.1	288.1
State and Local Government	36.3	42.7
Households	86.3	149.4
Nonfinancial Business	111.5	96.0
U. S. Government	161.3	205.9
Total	395.4	494.0

FUNDS SUPPLIED TO DOMESTIC NONFINANCIAL BORROWERS IN U. S. CREDIT MARKETS

(Billions of $)

	1982	1983*
Private Financial Intermediaries	271.2	359.8
Commercial Banks	108.5	122.7
Savings Institutions	30.6	129.2
Other	132.1	107.9
Private Domestic Nonfinancial Investors	99.7	97.3
Other	24.5	36.9
Total	395.4	494.0

* First 3 quarters at a seasonally adjusted annual rate.

Source: Federal Reserve Flow of Funds

Table 6

OUTLAYS AND RECEIPTS AS PERCENT OF GNP

	Receipts	Outlays*
1985-1989	19.5	23.3
1984	18.8	24.4
1983	18.6	25.0
1982	20.2	24.4
1981	20.8	23.5
1980	20.1	22.9
1964-1979 (avg.)	18.8	20.5

* Including off-budget spending.

The CHAIRMAN. We will proceed under the early-bird rule. And the first member here this morning was Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

Mr. Secretary, as you well recall during the closing days of the session last year there was a great deal of discussion as to whether there should be tax increases to offset the deficit. And, frankly, there were some very anxious moments while waiting for a clear signal from the White House. I think it's very important at the outset that we make it clear exactly where the White House stands on tax increases; Whether there is any room for maneuver; that although it does not favor a tax increase, it's willing to acquiesce or yield to such a proposal. Can you speak for the administration? Sometimes it seems that the White House has talked with many voices as to what is the official and real position on a tax increase.

Secretary REGAN. As far as I can see, Senator, the President is the administration, and the President says that he does not want tax increases this year or next year. The President has stated that this year he would like to concentrate on this deficit reducing exercise. As far as revenues are concerned, on the loophole closing area.

And I would hope that this committee would work along with him, with us, on that in trying to close these areas. As far as next year is concerned, we go into indexing next year The President does want and will insist upon indexing staying in. As far as other increases are concerned, he does not want that.

He has asked me, as I said in my prepared remarks, to try to come up with a simpler and fairer tax system if I possibly can. I'm not sure we can accomplish that but we will give it a try.

If we can do that, if it were to raise additional revenues, that would merely be a side effect. We would not be going into this exercise trying to design a new system to raise additional revenues over and above what would be normal increases of the area of $75 billion or so that we anticipate will come from just growth in the economy.

Senator ROTH. I'm glad to hear you say that you do not favor a tax increase either this year or next year. But let me just show you that I think it is critically important that the White House, the President, constantly reiterate it or you are going to see this same effort to badger the White House into modifying that position.

I think it's interesting that your chart shows that income taxes have not decreased as a result of what has happened, but if I read it correctly, that revenue raised by the income tax as well as all revenues has increased over the past year. I think it's important to understand that revenue today is almost 20 percent of the GNP, as high as it has ever been, I think, in almost any period in the postwar period. I agree with you that it's not lack of revenue that is causing the deficits.

I was very happy to see the President come out strongly in support of spousal IRA's. Four or five years ago I initiated that proposal as a result of a call from a housewife in Delaware who said it wasn't fair that everybody could save but housewives, but housewives were adding to the real wealth of this Nation as well as those working in the private sector. Is this a top priority of the administration?

Secretary REGAN. Very definitely. It's one thing that we think is only fair. And particularly with my wife sitting behind me, I would be hard put to say that housewives don't work or add to gross national product. I think they do. And I think it is only fair that we treat them as we would a spouse who works outside.

Senator ROTH. I shall be happy to help push that as something I have long supported. And we did get a small start in that a few years ago.

But I would like to go back to the deficit, because that's the biggest game in town. The Democrats want to blame the Republicans, the Republicans want to blame the Democrats. And everybody knows that nothing very dramatic is going to be done during the current year because it is politically a hot potato. Now I'm concerned. For example, it's my understanding that the current budget on medicare is increasing at a rate of 14 percent per year. Now that means that outlays will double in a little more than 4 years on that particular program. And at that rate, outlays would be over $1 trillion, in the year 2000.

Now, frankly, nothing is going to be done unless you get a bipartisan consensus on how to approach that kind of a problem. The Democrats control the House, the Republicans control the Senate, and the White House. I wonder how we are going to be able to address this kind of a problem because it's a horrendous problem, and it's a very politically sensitive problem.

Would you care to comment on that?

Secretary REGAN. Well, it has to be, obviously, done in a bipartisan way since it affects so many people across the spectrum. We are going to have to do in medicare exactly that we did in social security. We are going to have to get a bipartisan group to study the problem and come up with some answers to it. I would suggest that the bipartisan group probably exists right here in the Congress, working with the administration. Whether we need outside experts or not, I wouldn't know. I'm not one of those in favor of commissions. I think that we could get together among ourselves and do it. But there is no doubt. I happen to be a trustee of that trust fund, and I know that that trust fund is going to be in serious trouble in 3 to 5 years if something isn't done about it. Either we reduce the cost of the services, which I think is the preferable way to do it, or we are going to have to reduce some of the types of services that can be provided under these provisions.

It's something that started off modestly. It's one of those Federal programs that has just grown, and grown, and grown. As you know, most Western European countries that have had programs of this type have eventually had to curtail them. They are doing that now in the Scandinavian nations. They had to do it in Great Britian and the like. And it's only natural that the more service you provide the more service people will use. And just at what point we determine that that's all we can provide or that we have to cut back on some of the costs of this—it's the fastest growing part of the CPI, medical costs. So somehow or another we have got to get a grip on that. And I think that in the medicare area the Congress and the administration has got to do it either this year or next year because by 1986 or 1987 it is going to be too late.

Senator ROTH. Well, I see an awful lot of politicans on both sides berating the deficit, but I don't see many that really want to go up and try to do something about it. I think it's critically important that we start working now.

My time is up, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Roth.

Mr. Secretary, let's just say we get together, and I think we will. In my view there are enough of us on both parties around here that trust each other that we can sit down, hopefully, starting next week, and go to work on this down payment. Now how much of the hundred billion dollars is in the budget? Say we make a down payment of $100 billion. How much of that is already in the budget? We are not talking about another $100 billion reduction, are we? Some of it, I understand, is already in the budget.

Secretary REGAN. That's right. It's hard to give you a direct answer, not that I'm trying to weasle out of it. But we have made some suggestions in the budget. About $26 billion of spending cuts. We also have about $14 billion in there for less interest on the debt as a result of reducing these deficits. That's $40 billion that probably would be considered as spending cuts in our budget. We've also suggested some $33½, $34 billion of additional revenues through loophole closings.

Now I don't imagine that all of that will be accepted by a joint group working on the problem. I suspect a good portion of that would be. Let's say half. So half would already be in the budget, and another half to come.

The CHAIRMAN. In other words, following on Senator Roth, there would be some flexibility. As I recall the President's state of the Union message, he said he hoped we could get together on noncontentious areas, so obviously we are not going to touch, on the spending side or the revenue side, areas that are in great dispute. So I would guess there would be some flexibility if we do have the negotiation, and I hope we will.

Secretary REGAN. Let me try to spell it out, Mr. Chairman, a little more clearly. We think this should be done, if it is going to be done, promptly because you do have a budget process here in the Senate, budget process in the House, that has to go on and be done. If we are going to do anything of this nature, we have to do it up front or not do it at all. If we try to string it out, and get into the summer with this, it will never be done, in our judgment.

Accordingly, that's why we suggested the less contentious items be discussed. We are willing to discuss anything. The President has said it publicly, the chief of staff has said it publicly, and I know others of us have also said it publicly. We are willing to discuss anything.

But it's quite obvious that if we get into a major discussion of major entitlement programs and how to cut those back, or a major scaling back, or a lot of additional items to be put on, in a political year such as this, I think we would bog down again just as we did in 1982. So what we are hoping is that the thing can be in the less contentious items. I suspect that this committee could come up with its share of items. And if the Ways and Means Committee could join in that and make the job of the joint group that much easier.

So what we are suggesting is that we get on with it, see if we can do it, and if we can, go ahead of the budget process.

The CHAIRMAN. Maybe I'm too optimistic, but I'm confident that there are enough of us on this committee—Democrats and Republicans—to accommodate the desire to reduce the deficit. I think everyone has the desire. And it's my hope that we can be players in the process. And I would hope that everybody would get their people named so we can sit down privately and go to work next Monday. And I assume you will be a part of that? Will you be a part of that group?

Secretary REGAN. The President has already said that Jim Baker will be his main contact person, and that Dave Stockman, and I, and Dick Darman will also be on that group. So the answer to your question is yes.

It's my understanding, Mr. Chairman, that the White House has had some calls this morning that indicate that there should be a meeting next week.

The CHAIRMAN. I think that's good news. It would appear to me that if we don't do it early on as part of the reconciliation that is on the floor now, then we are going to get tangled up in the debt ceiling. How long can we go on the debt ceiling? Do you think July, August?

Secretary REGAN. No way. We will put it this way. No earlier than mid-April. And from then on it's chancy, depending upon our cash balances in the bank and where we will come out. But there's no way we could get to July.

The CHAIRMAN. I just suggest that if we can do the deficit reduction ahead of that it might take some of the pressure off in passing the debt ceiling. The extension is hard to pass. And last year, as you know, it failed in the Senate. We would prefer not to have that happen this year. But if we can do the deficit reduction earlier, we may avoid that problem.

My time is up, and I yield now to Senator Pryor.

Senator PRYOR. Mr. Secretary, you made mention of a figure of $26 billion of cuts in this particular budget. Is that the correct figure?

Secretary REGAN. Right.

Senator PRYOR. Now, where are those cuts?

Secretary REGAN. They are——

Senator PRYOR. Just a general overview of where they are located.

Secretary REGAN. In the farm-support program, a minor amount in medicare that was one of the proposals that came up last year, some on the means-tested entitlements, that would be about $2 to $3 billion there, and the things that were passed last year in the House, I know, and I'm not sure about the Senate, of slipping the COLA's on pension plans for civilians, retired military, and veterans in order to make them symmetrical with the COLA's on social security, and then there will be some increases in non-DOD discretional spending, and some decreases in the same level. In other words, mostly keeping for the main programs at their 1984 level, which in effect is a decrease because of inflation.

That totals somewhere in the neighborhood of about $5 billion in 1985, and that should bring it up to about $6½ billion for 1985.

Senator PRYOR. And the budget also assumes that these $26 billion in cuts will pass or be implemented. Therefore, the interest on the national debt will be reduced. Is that correct?

Secretary REGAN. That's correct.

Senator PRYOR. So if those $26 billion in cuts are not actually made, then the interest on the national debt would not do down, it would go up, and the deficit itself would, in fact, be larger than $180-some-odd billion. Is that correct?

Secretary REGAN. That's correct.

Senator PRYOR. In the 3 years that the President has been in office, and this administration has been in office, we hear about cutting spending. In fact, I woke up this morning and I heard you, sir, on the "Today Show." I woke up to you saying let's cut spending. And I come here and you say let's cut spending. How much spending has the President cut in 3 years?

Secretary REGAN. As far as the non-DOD portion of the budget, the spending has been retained at about the same level of gross national product, as it was in prior years. So it has not been a cut in spending. It has been a reduction in the rate of growth. The rate of growth in Federal spending was at a rate of about 17 percent, as I recall, when we came in. It's been pared back to where it's about a little over 7 percent now, the rate of growth in Federal spending. So overall there has not been a cut. It's been a reduction in the rate of increase in Federal spending.

The CHAIRMAN. We've cut $66 billion in this committee over a 3-year period.

Senator PRYOR. Do you have any sense or feeling that we may be headed toward a lameduck session of this Congress in December?

Secretary REGAN. You are the first one that I have heard say that, Senator.

Senator PRYOR. I'm the first one that said that?

Secretary REGAN. First one I have heard say that we should have a lameduck session.

Senator PRYOR. I think if you took a little private poll——

Secretary REGAN. The first one that I have heard. Let me put it that way.

Senator PRYOR. Well, I think if you took a private poll with some of our Members possibly even here, or in the House, or wherever, I think you might find a growing sentiment that whatever the administration does may well be put off until a lameduck session. I'm beginning to sense that myself, and have so stated in the past.

Secretary REGAN. Let me put in another plea here, Senator, that that not apply to this deficit reduction package that the President has suggested. I think that people are expecting this sort of thing. I think that when people who have asked for this such as the majority of the House in last October when they were passing the reconciliation bill—they asked that there be a summit meeting of this nature. Others have called for a so-called summit meeting on the deficit-reduction package. I would hope that we wouldn't put that off to a lameduck session.

Senator PRYOR. Mr. Secretary, my time is going to expire in a moment. One final question. If we proposed a freeze of 1985 expenditures at 1984 fiscal year levels, just a freeze, would you support that? Would this administration support a budget freeze?

Secretary REGAN. Well, first of all, I don't think you could have a freeze; particularly, in the entitlements with the COLA's and the like. They are geared to inflation. So you would have to go along with that. And I would think also as far as defense is concerned, there we have committed ourselves in previous years through budget authority to an increase in outlays this year for defense. To interrupt those programs, I think, would be counterproductive. You would throw the production lines off and so forth. So I don't think you could achieve a freeze.

However, I would point out to you that for a great many items in this budget we have invoked a freeze at the 1984 level.

Senator PRYOR. My time has about expired, Mr. Secretary. Thank you.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Secretary, in 1982 we went through a grueling effort in the Finance Committee and the Ways and Means Committee to pass certain loophole-closing measures. And the reason it was difficult is that some of us feel that it is harder to pass specific tax measures aimed at closing particular loopholes affecting relatively small groups of taxpayers than it is to do something that is across the board and affects everybody. And what we found in 1982 was even larger than normal crowds of lobbyists outside the Finance Committee room, and people who were staying up with us all night, the conferees on that bill, to monitor everything that was going on. So some of us have felt that if we are trying to close the deficit, it's easier to act in big strokes, broadly affecting virtually everybody in the country than to try to single out specific areas or specific groups that would howl particularly loudly when we act.

Last year in the fall we came pretty close in the Finance Committee at least to reaching a bipartisan consensus, I think, which would have involved the majority of both the Democrats and the Republicans for some pretty big measures to reduce the size of the deficit. And we were talking less in terms of a laundry list of little items than in terms of some very big items.

I take it that the administration, at least for this year, rejects that sort of broad-based approach and would rather have us concentrate on specific loopholes and particular spending items that we can cut.

Secretary REGAN. Yes, Senator, that is our opinion. Although it might be easier to pass legislation perhaps in this committee, perhaps in the Senate—although I'm not certain of that—it would be more difficult in the other House to pass an across-the-board increase. And rather than the easy way out, we think it a lot fairer to try to close these loopholes that are putting many taxpayers at an advantage over others. We think that that is something that we should do anyway, regardless of what type of tax proposal—

And I also call to your mind why we didn't do it again this year. We sent up last year a so-called contingency tax. And in there was a tax on energy, and a surcharge on individuals and corporations, and the like, the sort of thing you are suggesting. And as Senator Bentsen said, it had less life than a second lieutenant. Although, Senator, I remind you both of us were second lieutenants and we managed to survive.

I don't think that we wanted to send that up again, that type of thing, in order to have it scorned and thrown out within 24 hours so we decided to take this other route which we think is fairer and more practical.

Senator DANFORTH. Let me just ask you some more particular questions along this line. One of the things that we considered that Senator Boren and I were talking about particularly last year was a short duration of change in the indexing formulas for both tax indexing and nonmeans-based entitlement indexing so that the indexing would not be at the full CPI, but at something less than the CPI. The theory being that such an approach would affect all taxpayers. It would also affect recipients of Federal programs. It would touch everybody, and therefore people would see that it was fair. And that the dollars would be significant if we did that.

Would you say that at least for this year that it would be impractical for us to pursue the indexing adjustment proposal?

Secretary REGAN. Yes; I would, because I don't think you have got the other side of it. Even if you have got the delay or got a reduction in the amount of indexing of the tax side, since the social security commission came to its agreement, and that was passed by the Congress and enacted into law, that portion is no longer touchable, at least not this year.

Senator DANFORTH. Is that the administration's position or is that your just political assessment of the likelihood of Congress doing that?

Secretary REGAN. Both.

Senator DANFORTH. Both. So in other words the administration just as a matter of policy would oppose such an alteration in indexing?

Secretary REGAN. Yes, it would.

Senator DANFORTH. Mr. Secretary, you said that everything is on the table, but if on the spending side indexing isn't on the table, and if on the tax side indexing isn't on the table and rate increases aren't on the table, and if military spending is going up a real increase of 13 percent, which the administration has asked for, it would seem that what is on the table is tax loopholes and domestic appropriations. Is that correct?

Secretary REGAN. No; as I said in answer to the chairman, we are willing to discuss anything, but we want to get into the less controversial items in order to do it quickly. I would submit that changing indexing and changing some of the major entitlements is very controversial and we would bog down on that. So that's why, although we would discuss it, I don't think it practical to assume that that would be doable. And I said nothing about defense. We are willing to discuss defense. But the question is how much, where, why. We know that the Grace Commission has suggested many ways in which savings can be made in our defense establishment. That type of thing we are willing to discuss.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Secretary, it just seems to me that if the administration wants a down payment, it implies that it will also want a later, larger payment. Is that a fair inference for us to draw that when the administration says we need a down payment to get deficits down?

Secretary REGAN. Yes; a a matter of fact, I'm not sure whether it's in the budget report from the President or the President's economic message, which is coming today to the Congress. But he refers to that specifically.

Senator BAUCUS. If we agree that deficits are bad and if there is to be a larger payment, why don't we have a larger down payment this year? Why not make a greater effort his year?

As I listened to you in answering some questions of Senator Danforth, it sounded like you don't want to propose big items because they are too controversial. Is that the main reason why you don't want to send up these bigger down payments?

Secretary REGAN. You must remember that the $100 billion figure that we keep mentioning is not a ceiling. That can be a floor. If there are other items where spending can be cut, where things can be done, again, we are more than willing to try to join in such an effort.

Senator BAUCUS. Here's the problem I have. On the one hand I hear you say that more substantial proposals would be controversial. Congress might not pass them. They may run into opposition. If not in the Senate, then in the House, et cetera. Unfortunately this tends to be a self-fulfilling prophecy. The more the administration says, well, gosh, they are not going to pass the Congress, well, the more likely it becomes that they indeed will not pass the Congress. This pattern shows a lack of political will on the part of the administration and perhaps on the part of the Congress.

It seems to me that any administration; particularly, an administration which wants to get deficits down, should lead. It should be upbeat. It should try to find ways to meet the challenge to get these deficits down rather than to continuously say, well, no, it's controversial, it won't pass, and so forth.

A second concern I have is this: The administration didn't send up a surcharge or energy tax this year. I think not because it was afraid that the Congress wouldn't pass it, but rather perhaps because it was afraid the Congress would pass it. As you know, the members of this committee, under the very able leadership of Chairman Dole and Senator Danforth and Senator Boren and others, has worked very, very well together to fashion a significant bipartisan package to get these deficits down. And I am a little concerned that perhaps the administration didn't repropose some of the major items like the surtax of energy tax not because they wouldn't pass the Congress, but either because they would pass—especially since this committee was prepared to act along those lines or because the administration doesn't want to lead.

These are the two concerns that I have when I hear talk about a down payment. It sounds small. And I'm really not sure why we don't have a bigger payment.

Secretary REGAN. Let me try to allay some of your concerns. First of all—answering the second part first—last year on these contingency taxes, we based that contingency on getting some spending cuts; not just to raise taxes. That's not what we came here to do. It was not to raise taxes and to continue the upward movement of Federal spending as a portion of GNP. We wanted to bring that down. That being the case, we know that if we say, well, let's get together and raise taxes that we won't get the spending cuts. We wanted to see the spending cuts first. We don't think that we did get all the spending cuts in 1982 that justified the $78 or $80 billion of TEFRA.

Senator BAUCUS. On that point, Mr. Secretary, we were proposing a $150 billion deficit reduction package on a dollar for dollar basis. That is, for every dollar in spending cuts, absolute cuts, a dollar of revenue would be raised. And we did that because we thought it was the only practical way to get the job done. The President wanted only to reduce deficits by cutting spending, Tip O'Neil only by raising revenue. We felt that we ought to get both players together. And the only way to get together is to work together on both spending cuts and revenue increases.

Now Senator Roth, as you know, has a hard time raising revenue. There are other Senators on this committee that have a hard time only cutting spending. But we are working very closely and very well together to try to do this on a pragmatic, even and handed basis. So I want you to know that we weren't only looking at revenue. We were looking also at spending, on an equal basis.

Secretary REGAN. Well, I grant you that this committee—and I have the highest regard for this committee and its chairman—certainly is on the right line and on the right track in doing that. But getting it through the rest of the Senate and then getting it through the House is something we also have to consider.

Senator BAUCUS. Shouldn't the administration, though, want to help us get it through the Senate and the Congress?

Secretary REGAN. We want to help but we want to make sure that first of all come the cuts; not make it easy just to spend money.

Senator BAUCUS. Shouldn't we do it both at the same time?

Secretary REGAN. If we could. But I know of no procedure that will allow that.

Senator BAUCUS. Shouldn't we try to find a way? Find that procedure?

Secretary REGAN. We tried it. And as you will recall, it broke down in the Rules Committee in the House last year trying to get anything of that nature. The budget process literally has not functioned well in the last 3 years of this Congress. So that's what led us to this conclusion. That the way to do it this year is to send up a broad-base line budget, show people what will happen if nothing is done this year in the Congress except some very minor things. You get a $180 billion deficit. But if we work hard, we can reduce that. And next year, with less politics involved, we will be able to accomplish more hopefully.

Senator BAUCUS. Well, I don't know if we can afford to wait a whole year. We've got to do a lot this year.

Secretary REGAN. One answer on that—I think from the point of view—the main cause of concern here is whether or not we at Treasury are going to take too much savings, and whether or not we are going to push business out of the savings pool and gobble it all up ourselves. I do not see that happening. And most flow-of-fund analyses that are made by Wall Street gurus do not show it happening in 1984. That's why I think we can afford to go for the downpayment this year. We don't have to worry about the crowding out. We do have to worry, though, in 1985.

Senator BAUCUS. I'm not that concerned about Wall Street gurus. I'm more concerned about the average American who knows that these deficits are going to be our ruination unless they are reduced sooner rather than later.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman.

Mr. Secretary, I look on this budget that has been sent to us yesterday as nothing more than a stalking horse. And what I heard Dr. Feldstein say on a talk TV show this morning virtually admitted that when he talked about raising an additional $100 to $150 billion over the next years, in addition to what is proposed in this particular budget. And that would be only cutting it by a quarter.

And, frankly, I think it's based on some very rosy projections that we will have a very difficult time seeing come about. And I would particularly say that about the interest-rate projections that have been shown. You talk about reducing interest rates between now and 1989 by almost 50 percent. We have never in our history had a recovery accompanied by anything approaching the type of drop in interest rates that you are projecting.

Frankly, in these kinds of things I think it's one where the President has to lead. This idea of some kind of economic summit meeting. I remember attending one of those of President Ford. And all that turned out was a bunch of publicity releases.

The President has to send up what he really wants item by item in that budget. He has to exercise that kind of leadership. Last year the chairman of this committee worked to try to put together a coalition of us and to make some very tough cuts. And we were making substantial headway, but he got no support on that one from the President. I think the President has to get out front.

Let me give you a projection here on your interest projections. Back in your 1982 budget, you projected a budget surplus of $128 million in fiscal 1986. Your new budget projects $177 billion deficit. Instead of a big surplus, a substantial deficit in 1986. Yet both the 1982 and the 1985 budgets say that interest rates will be 8.5 percent this year and 7.7 percent next year. Is it reasonable to believe that you can go from a very substantial surplus to a very substantial deficit projection, and not influence interest rates at all? Do you believe that a swing of $200 billion Federal deficits will not affect interest rates? Would you comment on that?

Secretary REGAN. Certainly. First of all, as to the interest rate projections themselves, I don't think they are outlandish in the outyears. And first of all I have to throw in a caution here. Talking about interest rates 5 years from now is probably as about as nonproductive conversation as we can possibly have because the one thing you can bet is we won't be right. Very few people have the ability to foresee anything with clarity in 5 years.

What we have done in our assumptions, our economic assumptions, is to straight line certain characteristics, and that automatically pulls interest rates down.

Senator BENTSEN. Well in working on those assumptions, the $200 billion swing in that deficit from a major surplus to a major deficit, don't you think that should have some affect?

Secretary REGAN. Oh, sure. It's bound to have effect, if upon no one other than the Federal Reserve; in the last analysis it's the Fed that controls interest rates. Because they are worried as to how we are going to find the money to pay for those deficits.

Senator BENTSEN. But you see you don't bury the interest-rate projections, in spite of the difference in your assumptions.

Secretary REGAN. Our assumptions here are similar to those of most of the major econometric forecasters. What you do is you take the 2 nearby years and then you project from there. Now what we have done here is to say, well, on the basis of our budget, plus what we assume to be actions that will be taken by the Congress to reduce these deficits to where they come down into the $123 billion or less than $100 billion in the outyears, based upon that, you could expect in a growing economy where the gross national product will be $5½ trillion at that time, that the savings pool will be so large that the Federal Treasury will not be absorbing anything near 50 percent of it. There will be plenty out there for business.

A 5½ percent T bill rate is not outside the realm of probability. That, in effect, is higher than it was in the seventies for a long period, the decade of the seventies. So what we are projecting is that in the eighties we will have a much higher T-bill rate than we had in the seventies. And yet we had deficits in those years that as a percentage of gross national product are somewhat similar to the ones we are assuming here.

Senator BENTSEN. Well, Mr. Secretary, I will just have to say there is no historic precedent for what you are projecting in that kind of situation.

Secretary REGAN. Let me tell you we had that, Senator, in 1980 and 1981. We had interest rates come down from 21½ percent down to 11 percent in the period from 1980 to 1982 in spite of mammoth deficits. So there is a historical precedent.

Senator BENTSEN. Well, I don't think you have when you have—you have a recovery maturing, as you would anticipate at that time. You usually find that interest rates will rise or at least remain stable. You make another projection of 7 years of robust growth. That's about twice as long as the usual postwar recovery period. That's another on that side, on the recovery side. Robust growth substantially longer than has historically happened.

Secretary REGAN. Well, as far as that is concerned, in the period from 1961 until about 1967 or 1968, we had a similar period in our recent economic past of just that. The average post-World War II recovery has been about 39 or 40 months, 3½ years. So at this particular point, what we are saying—we took a straight line projection of 4 percent for our growth. Now in some years that could be 5 and some years that could be 2. We will have an average, is what we are saying, coming out of four for assumption purposes.

Senator BENTSEN. Well, Mr. Secretary, I know in an election year it is—when you get the budget projections, it is always the administration's role to take the optimistic viewpoint. But in each of these things—in growth and interest rates—you have taken the most optimistic I have seen of any economist. And I wish you well in it. But if you are not successful in it, and you find your interest rates continuing at the same level, behaving normally, let's see what you are going to look at.

The Government will be paying over $200 billion just as interest on the debt by 1988. And such payments would comprise 20 percent of the Federal budget. Deficits would be higher than they are today, and they would be on a rising trend. But the real trouble, because of this built in claim on Federal revenues, balancing the Federal budget, will be almost impossible. The Federal Government would have to take in $6 dollars for every $5 dollars it spends just to stay even. Whereas, today we take in only $4 for every $5 we spend. So you would reverse the roles. And I think it would be an extremely difficult burden that we would pass on to the future of this country.

Secretary REGAN. That is in accordance with what the CBO is saying for its forecast for the outyears. We differ with them on interest rates. They say that interest rates are going to stay high there. We don't know what their savings projections are or how they feel about foreign capital coming in, which has been another source of savings for us. We don't know exactly why they have arrived at their conclusions. We hope sometime to be able to sit down to discuss that with them.

But, again, I repeat. Two years ago, you will recall, we had a rather dismal forecast. And we were chided for that. Three years ago we had a very rosy scenario. We were chided for that. So it seems that we can't win no matter what we come up with.

The one that we have this year is in the mainstream. If you take the blue chip forecast of some 43 leading economic forecasting organizations and look at our 5 year projections and theirs, we are even with them on the first and second and third year. And then it is just assumptions from there on out as to what happens in the third and fourth and fifth year.

Senator BENTSEN. Mr. Secretary, I think these interest rates, with the inflow of capital that they help bring about, with the change in the exchange rates with the yen and with the mark, I think they are leading to the mismantlement of the U.S. industry. And I think it's absolutely critical that we try to bring them down. And I happen to believe that if we can bring these deficits down it will have an affect on those interest rates.

Secretary REGAN. I would agree with you on that, Senator. There is no disagreement between us on that. If we can get these deficits coming down, this makes the Fed's job easier in its monetary policy. They can ease up somewhat on money, bring interest rates down. As that happens gradually the dollar is going to decline. Now it won't happen overnight, I don't think. But that will then tend to improve our trade deficit. I agree with you. I think the trade deficits are horrible.

Senator BENTSEN. Thank you very much.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

Mr. Secretary, we welcome you on what I suppose is the last budget cycle that you will be up here with.

Secretary REGAN. Don't bet on it, Senator. Maybe the thought is father to the——

Senator MOYNIHAN. I meant that it would be more than even could be asked of a former marine to do the job for 5 years.

[Laughter.]

Senator MOYNIHAN. As the time goes by, we get interested in what are the major changes that the administration and your Treasury Department have brought to the country. One of the unanticipated ones is that you have made big government cheap. You get a dollar's worth of government, whatever it is, for $.75 worth of taxes. And, therefore, it's not surprising that at the percentage of GNP, the Federal Government is at the highest level it has been in history apart from the Second World War. That I don't think you expected but you did bring it to us.

One of the problems we have making any changes in spending or taxes is that the deficits are so huge that nothing would make a real difference anyway. If it was your plan to make big government cheap, you have been successful. And if not, that's the way the world goes. And as someone from Wall Street, you know you can't always predict the future.

But I want to ask you something that really puzzles me and that I don't know the answer to. And that has to do with the rise of the interest payments on the public debt as an element in the budget. I mean I have been in and out of Washington long enough to remember when you were told by the Bureau of the Budget that we have to have some public debt because there has to be some securities out there that are absolutely secure in order that there can be trust funds and things like that. And you would be taught in economics 101 that anyway the national debt is owed, we owe it to ourselves, so it doesn't matter.

Now according to your projections here—and the CBO is much less optimistic, as you know—but just take your estimates. By 1987, half of the individual income taxes will go to pay interest on the public debt. Now it seems to me that has got to involve a transfer of resources from one class of people to another. I cannot but think that the persons who own the public debt are not just a surrogate for the persons who have jobs and pay income taxes. And I wondered if the largest event in the Reagan years will be that Americans will start in very large numbers working to pay interest to people with capital. That is, there really will be a change in the position of capital in the country.

A third of the Members of the U.S. Senate are millionaires so they find that this is something they can live with. And I hope after all those good years that you can live with it. But do we know who owns the public debt? Do we know for example—you made the reference to how much of money is coming in from abroad. How much of it are we going to be paying to Saudi Arabia or Geneva? Who owns the public debt? Are we now going to get into a situation where Americans who work in factories are really paying a lot of their money to persons who have trust funds?

I'm serious.

Secretary REGAN. What I was just saying to my economist is that—for the record we will actually break out the figures. I'm quoting these from memory.

[The figures from Secretary Regan follow:]

Ownership of the Public Debt

The following provides data on ownership of the Federal debt and comments on how interest payments on this debt might affect the distribution of income.

Ownership of Public Debt Securities

Table 1 attached provides data on ownership of public debt securities as of year-end 1980, year-end 1982, and September 1983, the latest month for which figures are available. Attached also is the table from the Treasury Bulletin containing the most recent data. Relevant footnotes may be found in that table.

As may be noted from Table 1, a little over 70 percent of the debt is privately held (outside U.S. Government trust accounts and the Federal Reserve). About 12 percent of the total is held by foreign investors, a share that has declined markedly over the past few years. It was about 17-1/2 percent at the end of 1978.

The "other" category of holders is large and growing. It includes corporate pension funds, private nonprofit institutions, savings and loan associations, mutual savings banks, credit unions, and miscellaneous other organizations.

Individuals hold a substantial share of the debt directly (9.3 percent in September 1983) and an additional share indirectly in the form of money market fund shares and claims on corporate and state and local government pension funds. Individuals, of course, as stockholders own the commercial banks, savings and loans, corporations, and other holders of major portions of the debt.

Impact on Distribution of After-Tax Income

Data are not available to measure the impact on the distribution of income and wealth of taking dollars from taxpayers and transferring those dollars as interest payments to holders of the public debt. Quite generally, however, interest income from all sources is spread across all income classes more evenly than the burden of income taxes.

Inequalities in distributions of income, wealth, and tax burdens are often measured by Lorenz curves. The chart attached plots those curves for interest income and for taxes paid, based on tax return data for the year 1981. A diagonal (45°) line would represent perfect equality of distribution. The greater the departure from that line, the greater the inequality. As may be noted from the chart, inequality of the distribution of interest income received was substantially less than that of income taxes paid, both based on tax returns filed as classified by size of adjusted gross income. As an example, roughly 24 percent of all interest income reported by tax filers was received by the roughly 50 percent reporting the lowest adjusted gross income (under $14,000). These same one-half of tax filers paid about 8 percent of income taxes in 1981.

This, of course, does not indicate how the distribution of after-tax income might be affected by an increment in the public debt. It is suggestive, however, that debt holdings of all types are quite widely dispersed across income groups and that interest payments would not go predominantly to one group.

Ownership of Federal Debt

	Level, billions of dollars			Percent distribution		
	Dec. 1980	Dec. 1982	Sep. 1983	Dec. 1980	Dec. 1982	Sep. 1983
Public debt securities - total	930.2	1197.1	1377.2	100.0	100.0	100.0
U.S. Govt. accounts	192.5	209.4	239.0	20.7	17.5	17.4
Federal Reserve	121.3	139.3	155.4	13.0	11.6	11.3
Privately held	616.4	848.4	982.7	66.3	70.9	71.4
Commercial banks	112.1	131.4	176.3	12.1	11.0	12.8
Individuals	117.1	116.5	128.5	12.6	9.7	9.3
Savings bonds	72.5	68.3	70.6	7.8	5.7	5.1
Other	44.6	48.2	57.9	4.8	4.0	4.2
Insurance companies	24.0	39.1	n.a.	2.6	3.3	n.a.
Money market funds	3.5	42.6	24.0	0.4	3.6	1.7
Corporations	19.3	24.5	35.5	2.1	2.0	2.6
State and local govts.	84.4	113.4	n.a.	9.1	9.5	n.a.
Foreign and international	134.3	149.4	160.8	14.4	12.5	11.7
Other	121.7	231.5	n.a.	13.1	19.4	n.a.

Source: *Treasury Bulletin*

OWNERSHIP OF FEDERAL SECURITIES

Table OFS-1 - Distribution of Federal Securities by Class of Investors and Type of Issues

[In millions of dollars]

End of fiscal year or month	Total Federal securities outstanding	Interest-bearing public debt securities: Total outstanding	Held by U.S. Government accounts: Total	Marketable	Nonmarketable	Public issues held by Federal Reserve banks
1979	834,751	819,007	187,683	11,379	1/176,304	115,858
1980	914,317	906,402	197,743	10,076	187,667	120,[illegible]
1981	1,003,947	996,495	205,470	5,[illegible]	199,[illegible]	124,[illegible]
1982	1,146,96[illegible]	1,140,883	210,430	7,944	202,[illegible]	134,[illegible]
1983	1,38[illegible]	1,375,751	239,321	5,887	233,136	155,421
1982-Sept	1,146,96[illegible]	1,140,883	216,004	7,944	208,06[illegible]	134,[illegible]
Oct.	1,167,[illegible]	1,16[illegible]	216,994	7,661	209,[illegible]	13[illegible]
Nov.	[illegible]	1,160,[illegible]	202,[illegible]	5,[illegible]	197,[illegible]	[illegible]
Dec.	1,2[illegible]	1,19[illegible]	209,355	5,576	203,[illegible]	139,[illegible]
1983-Jan.	1,2[illegible]	1,20[illegible]	208,[illegible]	5,[illegible]	202,[illegible]	[illegible]
Feb.	1,22[illegible]	1,21[illegible]	20[illegible]	r6,[illegible]	r19[illegible]	[illegible]
Mar.	1,2[illegible]	1,242,[illegible]	20[illegible]	7,06[illegible]	19[illegible]	13[illegible]
Apr.	1,2[illegible]	1,242,[illegible]	2[illegible]	5,[illegible]	19[illegible]	[illegible]
May	1,2[illegible]	1,2[illegible]	22[illegible]	5,[illegible]	22[illegible]	[illegible]
June	1,3[illegible]	1,316,111	22[illegible]	5,904	222,[illegible]	[illegible]
July	1,331,[illegible]	1,32[illegible]	224,[illegible]	5,778	218,9[illegible]	14[illegible]
Aug.	1,353,[illegible]	1,34[illegible]	225,[illegible]	5,[illegible]	219,742	1[illegible]
Sept.	1,38[illegible]	1,375,751	239,321	5,887	233,136	155,421

End of fiscal year or month	Interest-bearing public debt securities—Con.: Held by private investors: Total	Marketable	Nonmarketable	Matured public debt and debt bearing no interest	Agency securities: Total outstanding	Held by U.S. Government accounts and Federal Reserve banks	Held by private investors
1979	515,[illegible]	379,[illegible]	13[illegible]	7,512	7,232	1,614	5,6[illegible]
1980	567,[illegible]	463,[illegible]	1[illegible]	1,79[illegible]	6,616	1,625	5,[illegible]
1981	6[illegible]	5[illegible]	114,22[illegible]	1,3[illegible]	6,[illegible]	1,5[illegible]	4,9[illegible]
1982	7[illegible]	6[illegible]	108,[illegible]	1,[illegible]	4,952	1,34[illegible]	3,612
1983	9[illegible]	862,[illegible]	118,[illegible]	1,4[illegible]	4,679	1,1[illegible]	3,479
1982-Sept	7[illegible]	6[illegible]	108,[illegible]	1,1[illegible]	4,952	1,340	3,612
Oct.	7[illegible]	6[illegible]	108,[illegible]	5,[illegible]	4,[illegible]	[illegible]	3,[illegible]
Nov.	[illegible]	[illegible]	110,[illegible]	[illegible]	4,[illegible]	1,256	3,[illegible]
Dec.	[illegible]	7[illegible]	11[illegible]	[illegible]	4,924	1,[illegible]	3,[illegible]
1983-Jan.	[illegible]	[illegible]	1[illegible]	1,4[illegible]	4,[illegible]	1,2[illegible]	3,62[illegible]
Feb.	[illegible]	r7[illegible]	r120,[illegible]	1,5[illegible]	4,[illegible]	1,2[illegible]	3,[illegible]
Mar.	[illegible]	r7[illegible]	r109,[illegible]	1,4[illegible]	4,[illegible]	1,225	3,[illegible]
Apr.	[illegible]	r7[illegible]	r115,[illegible]	5,0[illegible]	4,7[illegible]	1,22[illegible]	3,[illegible]
May	[illegible]	r81[illegible]	111,727	1,465	4,7[illegible]	1,2[illegible]	3,[illegible]
June	[illegible]	r8[illegible]	r11[illegible]	1,470	4,737	r1,2[illegible]	r3,5[illegible]
July	[illegible]	8[illegible]	11[illegible]	0,210	4,715	1,195	3,516
Aug.	[illegible]	8[illegible]	116,7[illegible]	1,4[illegible]	4,6[illegible]	1,190	3,4[illegible]
Sept.	[illegible]	862,[illegible]	118,61[illegible]	1,4[illegible]	4,679	1,1[illegible]	3,479

1/ Includes other nonmarketables of $2,[illegible].

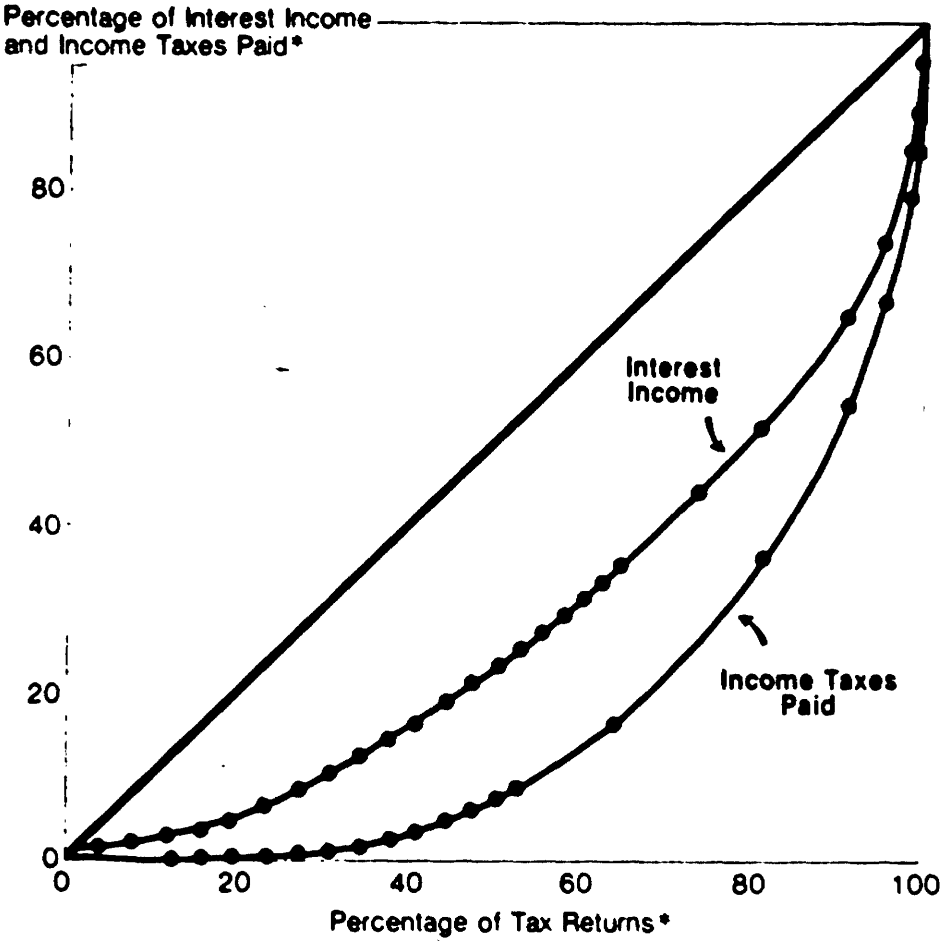
Table OFS-2 - Estimated Ownership of Public Debt Securities by Private Investors

[Par values 1/ in billions of dollars. Source: Office of Government Finance and Market Analysis in the Office of the Secretary]

End of month	Total privately held	Commercial banks 2/	Nonbank investors: Total	Individuals 3/: Total	Savings bonds 4/	Other securities	Insurance companies	Money market funds	Corporations 5/	State and local governments 6/	Foreign and international 7/	Other investors 8/
1976-June	376.4	9[illegible].4	28[illegible].0	96.1	65.6	30.5	14.4	0.8	23.3	33.3	69.8	47.2
Dec.	409.5	103.5	306.0	101.8	72.0	29.8	16.2	1.1	23.[illegible]	36.[illegible]	78.1	46.3
1977-June	421.0	100.[illegible]	3[illegible].3	104.0	74.0	30.5	16.1	.8	22.1	45.8	8[illegible].8	3[illegible]
Dec.	441.3	98.9	342.4	107.0	76.7	31.1	15.[illegible]	.8	16.2	50.0	109.6	55.1
1978-June	477.0	97.0	38[illegible].0	109.0	79.1	29.9	16.7	1.3	17.3	56.1	119.5	56.4
Dec.	508.6	95.6	413.6	114.0	80.7	33.3	20.0	1.5	17.3	62.0	137.8	6[illegible]
1979-June	516.6	88.1	428.5	115.5	80.5	34.0	20.0	3.8	18.6	68.[illegible]	119.7	83.1
Dec.	54[illegible].5	88.1	45[illegible]	118.0	79.9	38.1	21.4	5.6	17.0	71.8	123.[illegible]	9[illegible]
1980-June	5[illegible].2	97.4	46[illegible].0	116.5	73.4	43.1	22.3	5.2	14.0	7[illegible]	127.0	10[illegible]
Dec.	61[illegible]	112.1	50[illegible].1	117.1	72.5	44.6	24.0	3.5	19.3	80.4	13[illegible].3	12[illegible]
1981-Mar.	64[illegible]	11[illegible].0	5[illegible]	10[illegible]	70.4	38.0	2[illegible]	14.5	17.0	8[illegible]	142.9	143.[illegible]
June	6[illegible]	11[illegible]	5[illegible]	107.[illegible]	[illegible]	3[illegible]	2[illegible]	9.0	1[illegible]	[illegible]	141.[illegible]	[illegible]
Sept.	6[illegible]	1[illegible].7	5[illegible]	10[illegible].7	[illegible]	[illegible]	27.[illegible]	11.[illegible]	18.[illegible]	p9[illegible].7	13[illegible]	p1[illegible]
Dec.	6[illegible]	111.[illegible]	[illegible]	110.0	[illegible].1	4[illegible].7	2[illegible]	21.5	17.[illegible]	p9[illegible]	141.[illegible]	p1[illegible]
1982-Mar.	733.3	11[illegible].1	61[illegible].2	112.5	[illegible]	[illegible]	[illegible]	[illegible]	16.9	p10[illegible]	14[illegible]	p1[illegible]
June	7[illegible]	11[illegible].1	[illegible]	11[illegible]	[illegible]	[illegible]	32.[illegible]	2[illegible]	17.[illegible]	p1[illegible]	14[illegible]	p1[illegible]
Sept.	r79[illegible].2	11[illegible].0	r67[illegible]	11[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	p112.1	14[illegible]	p[illegible]
Dec.	8[illegible]	1[illegible]	7[illegible]	11[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	p113.4	14[illegible]	p2[illegible]
1983-Mar.	[illegible]	1[illegible]	[illegible]	11[illegible]	r[illegible]	r[illegible]	p[illegible]	[illegible]	[illegible]	n.a.	1[illegible]	n.a.
June	[illegible]	171.[illegible]	77[illegible]	r121.3	[illegible]	[illegible]	p[illegible]	[illegible]	[illegible]	n.a.	1[illegible]	n.a.
Sept.	[illegible]	17[illegible]	[illegible]	p1[illegible]	p[illegible]	p[illegible]	n.a.	[illegible]	p[illegible]	n.a.	p1[illegible]	n.a.

1/ U.S. savings bonds, series A-F and J, are included at current redemption value.
2/ Includes domestically chartered banks, U.S. branches and agencies of foreign banks, New York investment companies majority owned by foreign banks, and Edge Act corporations owned by domestically chartered and foreign banks.
3/ Includes partnerships and personal trust accounts.
4/ Includes U.S. savings notes. Sales began May 1, 1967, and were discontinued June 30, 1970.
5/ Exclusive of banks and insurance companies.
6/ Includes State and local pension funds.
7/ Consists of the investment of foreign balances and international accounts in the United States.
8/ Includes savings and loan associations, credit unions, nonprofit institutions, mutual savings banks, corporate pension trust funds, dealers and brokers, certain Government deposit accounts, and Government-sponsored agencies.

DISTRIBUTION OF INTEREST INCOME AND INCOME TAXES PAID



* Classified by size of adjusted gross income

Source: Internal Revenue Service, Statistics of Income 1981, Individual Income Tax Returns

Secretary REGAN. There is almost $400 billion of the trillion dollar deficit that is owned by the Federal Reserve and Government agencies. So a little less than 30 percent, probably, is in the hands of Government and Government agencies.

A great deal of the remainder of this—and we will have to find the exact figures—are in fact in institutions that are owned by or who are holding in trust money for the average person. I'm talking here about pension funds, insurance companies, things of that nature.

Another large percentage of the debt has been stripped in these so-called cats, tigers, other types of bonds, the zero coupon type of thing. Billions of dollars are in that area.

Contrary to the line of reasoning on the senatorial millionaires, I would doubt if many of them actually held Government bonds. I would suggest to them as a former investment advisor that they might be better off with municipal bonds.

Senator MOYNIHAN. I told you you are not going to be here next year. [Laughter.]

Secretary REGAN. That may well be. But I'm the one person incidentally who cannot own a U.S. Treasury security by law. I can't even own a savings bond, I found out much to my chagrin when I tried to stage a little ceremony where I would buy the first new type of savings bond. I can't do it. I can't own it. You guys put it in the rule, not me. [Laughter.]

But anyway I would say that as far as we are concerned, you do have a cause for concern here on the amount of our taxes that are going to go in the future to pay for the interest on the debt. That's why in all seriousness we would like to keep these deficits down if at all possible. I think we were victims in some way in this administration. Maybe you will call it a copping of a plea. But nevertheless, I think it's a matter of proof. We inherited a recession. There was a recession, as you recall, for a brief period in 1980 and then another recession came right on top of that.

As a result of that unemployment was quite high. If you take a look at the cyclical factors of the deficit, we still probably, on a full employment basis, could eliminate maybe $75 to $80 billion of the current deficit through cyclical factors. It's the structural part of the deficit that worries me. And I think that's where we in the administration and the Congress are really going to have to come to grips with that.

Senator MOYNIHAN. Mr. Secretary, I don't want to fuss with you about who caused what or where. You know the regard we hold you in here. Could I ask that you would tell somebody in the Department to see if we could get a new piece of paper on who owns the public debt?

Secretary REGAN. Certainly.

Senator MOYNIHAN. If we are going to pay half our income taxes to interest in the public debt, that is such a new experience that we really ought to know if there is a transfer of wealth going on here in what very likely is from middle-income persons to retired persons or perhaps or just to wealthy persons, and maybe just to wealthy persons in Zurich.

Secretary REGAN. My guess is it is probably going to institutions because our pension funds are growing enormously.

Senator MOYNIHAN. Sure. We know there is a lot of that.

Secretary REGAN. So are our insurance companies and other large holders. Even today banks are large holders of government securities.

Senator MOYNIHAN. There are not many large holders of banks. They tend to be people whose names you know.

Secretary REGAN. Most of them have large numbers of stockholders though.

Senator MOYNIHAN. But you will get us that?

Secretary REGAN. Yes.

Senator MOYNIHAN. Ask an economist not to make a case for or against the policies of the last few years, but to tell this committee just what it is dealing with in this regard.

Secretary REGAN. As Sargeant Friday used to say, just the facts, Senator.

Senator MOYNIHAN. Just the facts. Thank you very much.

Senator DANFORTH. Mr. Chairman, I just want to say that if all of this shows, as Senator Moynihan conjectures, that running up $200 billion deficits ends up as being a transfer from the ordinary people to the wealthy, Senator Moynihan will be more resourceful than even I had given him credit for being. That would be a stupefying result, I think. I too will be anxious to see that analysis.

Secretary REGAN. Well, there is another side to this. You have also got to figure out who is it that is getting the benefit of the funds that the Government is expending when it racks up this debt. Because there the Government is taking that money in from one area, and putting it out in other areas, whether social programs, or DOD, or wherever. But we will have to follow that part of the money also in the transfer of wealth idea.

The CHAIRMAN. We would be happy to have that. It would take some time, I guess.

Senator MOYNIHAN. We would like you to do it at the levels—your very high levels of professional, economic analysis from the Department of Treasury.

The CHAIRMAN. Have you had a chance to study the Mondale plan?

Secretary REGAN. No. I've only seen newspaper accounts. I have not had the plan itself.

The CHAIRMAN. We have candidate Reagan and candidate Mondale seems to be closing. So when we look at—I'm not a very good judge of who has anything wrapped up, but [laughter]——

But he calls for deferral of indexation—that would save $30 billion. He would put a lid on the President's tax cut for those with taxable incomes over $60,000—that would save $6 billion by 1989. A 10-percent surtax proposed by Mondale with incomes over $100,000 would generate $5 billion. At least $21 billion would be raised by 1989 by the imposition of such measures as tax on all corporations earning profits. He says that 90,000 profitable corporations pay no tax at all. And then they are going to have loopholes and abuses that would account for another $21 billion. Ten billion would be raised by stiffening the Internal Revenue Service enforcement procedures. He would go after these people—the compliance area that you mentioned. But there has been no real analysis of the Mondale plan. Is that correct?

Secretary REGAN. Not by us, Senator.

The CHAIRMAN. The point I make is that we are in the election year and I think if the one side said, well, we can't do anything because of Ronald Reagan, then I think we are going to say, well, what about Walter Mondale and we will end up doing nothing. And I would hope that we would just have this meeting.

Are you fairly optimistic now that we are going to get together?

Secretary REGAN. Yes. Because I detect from my conversations with committee chairman and ranking members that most of the affected committees of both the Senate and the House are willing to give this a try to see if it will work. And I do detect a good effort will be made by both sides, both sides of the dome as well as both sides of the aisle to try to make this effective.

I know we are going to push it.

The CHAIRMAN. They ask for one from the Senate side and then something from the House side to just sort of build a little package that way. My own view is that it wouldn't be too difficult, but I understand we have to meet before we can do that.

I'm going to yield to Senator Boren in just a minute.

Do you share the view expressed by Milton Freidman that the current Fed policy is too tight and may lead to a recession this year?

Secretary REGAN. It's hard to say. The Fed just went through its seasonal adjustments. And as a result, the money supply looks like it has been a little more accommodative than had previously been thought. There's no doubt that from July 1982 to July 1983 the Fed was very loose with its money supply, running over 13 percent.

According to the seasonals in the most recent 8-week period, the money supply has been running better than 6 percent. If the Fed stays on that course, that's plenty of money to continue this recovery. If they tighten it from here, that would be dangerous in my judgment. I think that we have to have a steady growth in the money supply. I don't think we can afford to cut it off. I don't think that the economy is overheating. I think that the fourth quarter of 1983, calendar quarter, indicated very clearly that the economy has slowed down. It's at a steady rate. We would like to keep it at that rate. But if the money supply is tightened over the next 3 to 4 months, we could have a falling off and actually abort the recovery if we are not careful.

The CHAIRMAN. Wouldn't it make it a bit easier both for Mr. Volcker and for everyone involved if we even got the downpayment? Wouldn't that be helpful in your opinion?

Secretary REGAN. Oh, yes. That's one of the things that I think the Fed is waiting for, a signal from the administration, from the Congress that they are serious about the deficits. And if they see that the deficits will come down a hundred or even slightly more over the next 3 years, then these figures that we are showing—$180, $175 billion level—if they are down in the $160, $150, $140 billion level makes their job much easier.

The CHAIRMAN. If, in fact, we could do, say, $100 billion plus, maybe more, in your opinion would that have any impact on the interest rates or is that enough to make any difference?

Secretary REGAN. Yes. I think it definitely would bring interest rates down, because, as I said, it makes the job of the Fed a lot

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easier and they don't have to worry that much about future inflation.

The CHAIRMAN. And I guess my final conclusion is that it is a matter of great priority. It seems to me that that should be the one thing that we ought to focus on. Not go through the whole budget game for 6 months. If we do that, it would be too late. We are prepared now. We don't need a budget resolution. We have enough ideas in this committee from both sides of the aisle to make our contribution to $100 billion or more. We are talking about the spending side too—medicare, medicaid, other areas that we believe we can do more than the administration recommends. So we just hope that we can have the meeting.

Senator Boren.

Senator BOREN. Mr. Secretary, I apologize for being detained and some of these points you may have already covered. The $100 billion downpayment on the deficit reduction, has the administration included in its budget proposals now before it the suggestions which would make that $100 billion of reductions?

Secretary REGAN. Not all of them, Senator. What I have said before on that is that we have made suggestions in this budget here for about $26 billion of cuts, and couple that with about $14 billion of less interest on the debt as a result of getting the deficit down. And we have put in about $33½, $34 billion of revenue increases.

Now we know that not all of that will be adopted. So what portion of that is adopted, we don't know. And my bottom line was that I think about half of the $100 billion is probably in this budget, the other half to come.

Senator BOREN. So we are really talking about another $50 billion roughly?

Secretary REGAN. But, again, I repeat. That does not have to be a ceiling. That could be a floor.

Senator BOREN. So really we would still have, if we got the other $50 billion, budget deficits. We are now projecting over $180 billion. We would have somewhere around $165 to $170 billion over the next 3 years if we got the rest of the suggestions.

Secretary REGAN. It would probably go down on more of a slope over the years because, as you know, what you do in the first year builds up over the second and third. So my judgment would be that it would probably go on a slope of $165 probably down into the $140 area for 3 years.

Senator BOREN. If it was felt that we could come up with additional savings to total the $100 billion downpayment, why didn't the administration just make those suggestions since it's the duty of the administration to present a budget? Why didn't the administration just present those suggestions to us now, lay them right out on the table, and see whether or not we couldn't just start to work on them instead of saying we will negotiate? If they are there to be had and there to be suggested, why not unveil them now in the original budget?

Secretary REGAN. Well, being candid, Senator, there are two reasons. One, a very practical reason. We tried that last year, and our budget didn't last 24 hours. And most of the cuts that we suggested were just ignored. As far as the other reason, we know this is a political year. And we know that many of the things that are going to be suggested either have a bipartisan approach or they are not going to succeed in getting through both Houses. So as a result we said let's send up a base line this year, and then tell the Congress that we are ready to discuss further cuts with them if, indeed, that's what they want.

Senator BOREN. We have discussed this before, and I'm very concerned. I certainly doubt that we could run deficits of $165 or $170 billion for the next 3 years and sustain a recovery. It seems to me we must look for much more dramatic reductions in the deficits. If we rule out any essential changes, any large items of revenue change, other than just the relatively small items that have been listed on the laundry list, if we rule out interest on the debt—if we make other reductions, of course, we impact that, but still we are talking somewhere in the neighborhood of 13 to 15 percent of spending—you rule out any major changes in the defense budget, which apparently the administration rules out, then if you rule out the 40-some percent that are included in the entitlement programs with the automatic cost escalators, we have really ruled out nearly all the income of Government and about 85 percent of the spending, which means it becomes impossible to make a dramatic deficit reduction.

Now if we had the political courage on this committee in a bipartisan way—and if it could be bipartisan with the votes on both sides of the aisle in this committee—to bring ourselves to take on the big items for a dramatic deficit reduction that would really do some good, if this committee with votes from both sides would come out with a majority for some action that would constrain the escalators on entitlement programs, the amount of escalators, percentage of escalator, would you and the administration support our effort if we could do that?

Secretary REGAN. Well, we've been more than willing to discuss it. It was our judgment in thinking this through prior to the President making his statement in the state of the Union message about this that that would not be practical this year. That we didn't feel that there would be enough of a majority in both Houses that would want to make a major adjustment this year to the entitlements.

You know we tried this last year with social security, and the majority of entitlements are in social security. And an adjustment to the social security was made last year so we didn't think it could be reopened again in 1984.

Senator BOREN. Well, let's suppose we surprised you and a bipartisan majority of this committee would do it, I think we would realize then to have any chance, we would have to have a very enthusiastic response from the administration to it as we tried to take it on through the full Senate and the House. Now some of us on this committee, of course, have stuck our necks out a political mile to make such a proposal. And it's a little discouraging. We would hope that you would break out the brass bands and at least applaud our courage and say this is what has to be done in order to get the thing into being. But I gather from your answer you really couldn't promise us any brass bands if we were to take that action. No balloons would be dropped probably.

Secretary REGAN. We would have to see what you were able to accomplish first, Senator. And then we would be willing to float all kinds of balloons. Maybe even shoot them down if they were just trials.

Senator BOREN. If the political risk became too great, we might have a few bee-bees lobbed our way. I see.

Let me ask one last question. We know that critical sectors of the economy—and one sector with which I'm particularly concerned for my State is agriculture—the overvaluation of the dollar is severely impacting us in terms of our total trade balance, and it has gone a long way to explaining why farmers in my State only had an income of $14 last year.

What can we do, if we are not going to take major action to reduce the deficit and impact the overvaluation of the dollar that way, is there anything that we can do to try to bring about a fair balance in the value of the dollar compared to other currency so that we can stop this hemorrhage in our trade balance because that's of great concern to very critical sectors of our economy? Do you have any proposals to make along those lines?

Secretary REGAN. Well, there are several things that probably will happen if economic history is to be repeated. First of all, no nation goes along as ours has with repeated large trade deficits and maintains a strong currency. Normally, the currency starts to weaken. And economists will tell you that eventually our dollar has to weaken if we maintain these large trade deficits and current account deficits. That we can't keep sucking in as much capital as we are to balance this off from abroad as we have. Eventually that has to stop. As that stops, the dollar weakens. Then the cycle starts all over again. But that does take time. And that's very little solace to a farmer who has to go on a season-by-season basis.

As far as the other things that can be done, I do think that real rates of interest in this country are much too high considering what we have been able to accomplish on the inflationary front. I think that if interest rates were to come down you would see the dollar weaken because one of the props under the dollar, no doubt, is interest rates.

The other thing will be recovery in other industrialized countries and in the less developed countries. Take Mexico, our next door neighbor. Mexico has a trade surplus with the United States for the first time in years. Why? Not because they are sending us so much. It's because they are not buying from us because they are not able to. As they recover in their economy, they can buy more from us. Same thing with Brazil.

The other industrialized nations have not emerged. Germany, England, France have not emerged as fast as we have. Gradually they are going to. As they do, people will want their currencies. And their currency will strengthen in regard to the dollar.

So there are many things that can happen over and above getting the deficits down. But I do agree with you. The first and foremost we should try it is by reducing deficits here.

Senator BOREN. I apologize, Mr. Chairman. One last question on the size of the deficit. And, of course, it does complicate it all because if the interest rate falls temporarily or the dollar weakens temporarily it improves the trade balance on the other hand, causes greater problems, we have less in-flow of capital from abroad. And if the Government borrowing was still so high it likely puts pressure to spike up the domestic interest rate. How long do you think we can sustain—and I realize you and I might differ in terms of our optimism about what economic growth would do to the deficits and how quickly and the legitimate basis for the position each of us espouse on that—let's say we continue a deficit this year in the neighborhood of $180 billion, and we have a deficit next year in that range. How long can we sustain deficits of the magnitude of $150 to $200 billion a year, and continue an economic recovery? Is there any point at which, if we find that we are continuing deficits of that size, for whatever reason, that you would expect the recovery to not be sustainable? Or can these just go on indefinitely? Could we run $200 billion a year for 5 years and sustain a recovery? Or do you think we would have to get it under control in 2 years? I realize you can't set a date, but what's your general sense of how long we have to work on getting these down either through economic growth or through budgetary control of spending or some other means before we really bump up against the choking off of the recovery?

Secretary REGAN. Well, I know that this year we can finance the deficit without crowding out business. I'm very worried about 1985 and whether or not we will crowd out there. I suspect we probably will start crowding business out in 1985. If we continue at the $200 or even $180 billion level into 1986, we would definitely be in trouble by that point. So that's why, again coming back to our theme, the President wants a downpayment this year and a lot of action next year in an effort to head that off before we do get into the 1986 potential.

Senator BOREN. Mr. Chairman, I appreciate the Secretary's answer. I would just say what worries me is if we waited until 1985, if we wait until after the election, it is going to make the solution to the problem a lot more difficult because if we wait until the crowding out starts, then we have interest rates going up, unemployment going up, and it becomes a lot harder, as we all know, to exercise budgetary discipline in the midst of what seems to be the beginnings of a recession than what seems to be in the midst of recovery.

So I hope we cannot only make a downpayment. I hope we could take a good chunk out of the principal of this deficit as well. And I hope that the committee may proceed along those lines.

Thank you.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Mr. Secretary, give us a guideline, if you would, at this time as to what you expect of this committee and the bipartisan group on this committee that Chairman Dole so skillfully, and I must say, inspirationally put together last October and November. Give us some guidelines on what you expect of us to present to you before you or the President will look at our product. Are we talking about a dollar cut in spending for every dollar raised in revenue?

Secretary REGAN. Well, Senator, I would like to be very candid and open at this moment, but prior to——

Senator PRYOR. Well, feel free to.

Secretary REGAN. I thought so. But prior to entering into negotiation with several individuals, one hardly lays out in public what one's negotiating position is going to be, and then walks into the negotiations. But let me hypothesize, if I might.

What we would be looking for would be agreement that we could proceed probably in smaller groups rather than one large body with the committee chairman and the ranking members being parts of those groups in the pertinent areas—budget and budget appropriations, revenues and so forth. And that those small groups try to focus on what the overall goal would be that would be mutually set by the larger group. And portions assigned out. And then through meetings with the full committee or otherwise, the chairman can report back what they think is doable in their particular area—the budget area, the appropriations area, revenue area. If that is done and then everybody signs off on it, we do have a bipartisan approach to the problem.

And if that is to be done, I'm sure that because of the knowledge and the skill of the participants, it can be done quickly unless we are going to get into real politics. My guess would be taking $100 billion as the floor, there probably wouldn't be $10 billion that would be in real contention. That we could probably get $90 billion rather quickly in general agreement because a lot of this stuff has already passed committee or passed one of the Houses. So I don't think we have to go back over plowed ground.

So I would assume as a hypothesis that that's the way we would proceed.

Senator PRYOR. I don't know if this is a figure, and I hope I'm not quoting you out of context, but I think last fall back in this room you mentioned a figure of some $70 billion in cuts, spending cuts, before the President would look at any proposal. Now is that within the ballpark?

Secretary REGAN. That was when we were talking last year about the contingency. And you will recall the contingency was about $50 billion or maybe $60 billion in additional revenues. And we said we would have to have generally a one-for-one or maybe hopefully a little bit more on the spending than on the revenue side. And I think that's where the $70 billion figure came from. But that's off the board. I mean that's last year, that's history. We are starting fresh on this one.

Senator PRYOR. Thank you, Mr. Secretary.

The CHAIRMAN. Mr. Secretary, we thank you very much. And I justed wanted to include in the record that there has been a lot of talk about in 1982 the President didn't get his $3 of spending cuts for every $1 of tax cuts. And we have done a little work on that. It is correct that the congressional budget resolution for 1983 called for $280 billion in spending reductions over 3 years and 98.3 in revenue increases, which amounts to about $2.80 in spending reductions for each $1 in revenues. In fact, at this point we have neither achieved all of the spending cuts or all of the tax increases. But I wanted to just for the record to indicate that only $126 billion, 45 percent of the $280 billion in spending reductions, were savings that were intended to come from congressional action. The remaining 55 percent or $154 billion of the assumed savings was to cover interest savings of administration management and initiatives.

According to the CBO and the Senate Budget Committee, we have been able to achieve about 70 percent or $87 billion of the $126 billion of the congressional savings have been achieved. And I will put that in the record.

We don't know how well the administration has done, but we know that interest rates fell after the action of TEFRA so I assume there was a significant amount.

The bottom line is we didn't get all the tax increases either. We lost withholding. That was about $9.4 billion over 3 years. And then what the insurance companies agreed to is going to fall short about $3½ billion. So the way we figure it out—we assume the administration did as well as we did—we got about $2.30 in spending reductions for every $1 in taxes rather than the $2.75 or $2.80 for every $1.

I don't know if that solves anything, but there has been a lot of discussion about that. These figures, we hope, are fairly accurate.

We are also going to be having a hearing next week on truck taxes. I guess you are indirectly involved. We've been working with Treasury. That's the primary responsibility of the Secretary of Transportation, who will be making her first appearance before this committee. And we are looking forward to that. [Laughter.]

She is but we are too. But we appreciate very much your expertise in this area. And I personally appreciate your efforts to include in the state of the Union message the downpayment concept. Obviously, if we all had our way we would want to do more. But as you have indicated, and I think others have indicated, economists from both parties, that this would be helpful. It would do something. It's better than doing nothing. And I think we spend so much time saying we can't reduce this or we can't change that revenue figure that we fail to address the alternative which is doing nothing. And I would guess you would agree that doing nothing is the worst alternative.

Secretary REGAN. I would very definitely second that, Mr. Chairman. I don't think we can afford to do nothing. If we do nothing, we jeopardize the economy of the country. And I think we have to do something.

The CHAIRMAN. And we are going to have the cooperation of Senator Boren and others in doing this. And we appreciate very much you appearing this morning. And we are going to get you out ahead of time.

Thank you very much.

Secretary REGAN. Thank you, Mr. Chairman.

[Whereupon, at 11:38 a.m., the hearing was concluded.]

ADMINISTRATION'S FISCAL YEAR 1985 BUDGET PROPOSALS

TUESDAY, FEBRUARY 7, 1984

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Chafee, Heinz, Danforth, Grassley, and Symms.

[The prepared statements of Senators Dole, Symms, and Grassley follow:]

OPENING STATEMENT OF SENATOR BOB DOLE

I am pleased to welcome you, Mrs. Heckler, to our second hearing on the administration's budget proposals for fiscal year 1985. As Secretary of HHS, you oversee the largest budget of any agency in the Government. This year the administration proposes to spend $318 billion through HHS on health and income security programs, an increase of $22 billion over fiscal year 1984. In fact, since 1981 outlays for HHS programs will have increased by 39 percent. So it is difficult to make the case that this administration has abandoned those who are truly dependent on help from the Federal Government.

While we have worked hard to restrain the growth in HHS programs over the past three years, particularly in medicare, spending continues to escalate. A quick look at the HHS budget shows why: 96 percent of all department spending is for entitlement programs.

Many have said that federal spending cannot be brought under control until there is a major entitlement reform. That is a convenient excuse for doing nothing this year. We shouldn't forget that the administration proposed $12.4 billion in spending reductions in medicare, medicaid, and AFDC in this year's budget.

While this is more modest than in previous years, it is doubtful that we will be able to achieve major entitlement reform, or restore solvency to medicare, if we are unwilling to consider even these small changes first. Nor is there much hope for a bipartisan down-payment of the budget deficit, if we cannot agree on the relatively modest spending cuts contained in the President's budget.

Welcome, Madame Secretary. We look forward to your testimony.

STATEMENT OF SENATOR STEVE SYMMS

Good morning Mr. Chairman. It is a pleasure to be here again to discuss the Administration's Budget proposals with regard to federal health care programs.

There is no doubt that the ever-increasing cost of health care and the fate of the Medicare system occupy two of the most pressing issues facing Americans today. Health care expenditures currently account for 10.5 percent of our GNP and by 1990, it is estimated that they will increase to about 35 percent of GNP. The Medicare system currently expends about $67 billion annually and by 1990 it is expected to cost the taxpayer about $100 billion per year. However, before the system costs the taxpayer $100 billion per year, the Health Insurance Trust Fund is expected to have depleted its resources by 1987. Obviously, neither the taxpayer nor the economy can afford to sustain the projected expenditures for health care or the Medicare system. It is equally obvious that unless the financial problems of the Health Insurance Trust Fund are solved, those who are dependent on the Medicare system—our senior citizens—will have their well-being jeopardized.

Any long-term solution to the financial problems of the Medicare program must be broad-based and include reforms to increase patient cost-consciousness as well as provider cost consciousness. Although some critics argue that more and better regulation of hospital rates and increased Social Security taxes will solve our problems, that position is more politically expedient than financially realistic. A sound program for slowing the rise in health care costs must involve everyone.

Last year, Congress made a significant step towards trying to install cost-saving initiatives by implementing the Prospective Payment proposal. That proposal is still being worked into our health care system, but I believe that we are already beginning to see the results by the major changes that are sweeping the health care industry.

Congress has still not implemented the proposals to increase cost-consciousness at the individual level, and I don't believe that we will actually be able to bring down our health care expenditures until the individual receiving the treatment realizes some of the cost. I was chagrined to see that the Administration's fiscal year 1985 Budget proposals did not include some of the proposals that were made in fiscal year 1984. I believe that the change in your Budget was a serious mistake and I would recommend that you again review your position.

Before I close, Mr. Chairman, I would like to say for the benefit of those present that raising Social Security taxes as a means of solving the financial problems of the Health Insurance Trust Fund is not a solution. In fact, at this point it will only aggravate the long-term problems of the trust fund because increasing payroll taxes will only increase the number of unemployed, and that in turn, will have a negative impact on the level of revenues financing the Medicare program. Furthermore, more than 50 percent of the working population pay more Social Security taxes than income taxes. Raising their taxes at a time when many workers are not receiving pay increases or are having to take a cut in wages is irresponsible.

Statement of Senator Charles Grassley

Mr. Chairman, clearly, Congress must take bold action to halt the alarming increase in the Federal deficit. This committee has the vast majority of entitlement programs under its jurisdiction, and I am most interested in hearing the distinguished Secretary's recommendations on what can be done in the entitlement programs to limit Government spending.

In my work on the Senate Budget Committee, I have long advocated a spending freeze as a way to force fiscal discipline on the various spending programs. Congress cannot rely on tax increases to close the deficit. Nor can we rely on such small savings as the $350 million achieved through eliminating the community services block grant program or other insignificant savings in various social services programs suggested in this budget plan. Proposing $652 million in AFDC savings and $2.1 billion in medicare and medicaid savings for fiscal year 1985 does very little to close the deficit, but does a great deal to inflame those groups who feel they are being unfairly singled out by this administration for more than their share of cuts.

Fundamental and broad-based changes must be made in Federal spending programs. Entitlements are gobbling up a greater portion of our total budget, with no end in sight to the demands for more spending. Congress has a history of embracing new social programs, which take on a life of their own. Congress sits back and watches these programs balloon, voting for larger expenditures, and using program popularity to their political interests. Congress has got to stop being so generous with the taxpayers' money.

It is time we have the courage to say "No". We cannot vote yes on every spending bill that comes along. That goes for the Department of Defense as well as for the Department of Health and Human Services. If we are serious about narrowing the deficit, we cannot afford to eliminate certain spending categories from careful scrutiny.

I am greatly concerned that the administration's fiscal year 1985 budget does not make any real progress toward the true reform. Most of the suggestions made in the area of entitlement programs are resubmissions of ideas which failed to generate must support last year. Even if the recommendations are approved by the Congress, savings in the programs under this committee's jurisdiction would total approximately $3 billion in fiscal year 1985.

I fully realize the difficulties in making substantive changes in our entitlement programs. Members of this committee do not have to search too far back in their memories to recall the debate on social security. Each of us had to swallow hard and accept provisions we personally did not like in order to restore solvency in the trust fund. Certainly, we can do the same to restore fiscal integrity to our national treasury. However, I will not be cajoled into accepting tax increases based on some promise of future spending restraints. I played that game in 1982 with TEFRA. Spending reductions must be real, and be broad-based. I remain hopeful that this administration will be pushing hard for entitlement reform so we can get this Nation back on solid financial footing.

I look forward to hearing the testimony of the Secretary on the Administration's budget proposal.

The CHAIRMAN. Just let me say briefly we are pleased to have Mrs. Heckler here this morning for our second hearing on the administration's budget proposal for fiscal year 1985. As Secretary of HHS, you oversee the largest budget of any agency in the Government. This year the administration proposes to spend $318 billion through HHS on health and income security programs, an increase of $22 billion over 1984. In fact, since 1981 outlays for HHS programs has increased by 39 percent. So it's difficult to make the case that this administration has abandoned those who are truly dependent on help from the Federal Government.

We have worked hard to restrain the growth of programs over the past 3 years; particularly medicare, but even then spending continues to escalate. A quick look at the HHS budget shows why. Ninety-six percent of all Department spending is for entitlement programs. And I just suggest that we do have some spending reductions to consider in this committee, some in medicare, medicaid, AFDC. We are going to obviously study those closely. It's still my hope that the group will get together and work out some downpayment on the deficit. And I guess some will be meeting tomorrow in the first effort to do that.

Madam Secretary, we are pleased to have you here. We appreciate the good work you are doing. And as I indicated when you came in, we are going to be meeting at a staff level at 2 and there will be someone here from HHS on child support enforcement, which is one of your top priorities. We would hope to have that worked out maybe today or maybe tomorrow; maybe even mark it up and report it out before the end of the week. If not, shortly after the so-called Lincoln Day recess.

You may proceed.

STATEMENT OF HON. MARGARET M. HECKLER, SECRETARY OF HEALTH AND HUMAN SERVICES, WASHINGTON, D.C.

Secretary HECKLER. Thank you, Mr. Chairman.

It's good news about your child support enforcement meeting this afternoon. Hopefully, we can resolve it on the Senate side and have legislation that can be signed by the President.

The CHAIRMAN. There are some areas of difference. And there are always those who would like to liberalize the financing of the program. I think the administration proposal was a pretty good proposal. We will be keeping in touch with you on a personal basis too.

Secretary HECKLER. Thank you so much, Mr. Chairman.

I would also like to say to you, Mr. Chairman, and members of the committee, that I have a very extensive statement which would be burdensome to read at this point. I would like to ask your consent to have it inserted in the record.

The CHAIRMAN. Right. It will be included in the record. And, of course, if you could summarize, it would be welcome.

Secretary HECKLER. Yes.

The CHAIRMAN. And you would still have somebody here.

[The prepared statement of Secretary Heckler follows:]

STATEMENT BY MARGARET M. HECKLER

Mr. Chairman, Members of the Committee:

It is a special pleasure to be here today to discuss the legislative proposals in the Department's 1985 Budget which affect the programs under the purview of this Committee.

In 1985, the Department will provide direct benefits to nearly one in every four Americans.

- o Approximately 50 million of this country's poor, aged and disabled citizens will have their medical needs met by Medicare and Medicaid. Spending on these two programs represents 29 percent of the HHS budget and 10 percent of the total Federal budget.
- o More than 49 million people will receive assistance from the Department's income security programs for the aged, disabled and poor.

Our Fiscal Year 85 Budget reflects our commitment to maintaining the essential services to the people served by these programs. It also reflects our commitment to keeping these programs financially sound by building on recent accomplishments to restrain their growing costs.

Before I review the specifics of our legislative program for fiscal year 1985, Mr. Chairman, I would like to acknowledge this Committee's contribution in facilitating the passage of two landmark pieces of legislation which were reflected in last year's budget.

The Social Security Amendments of 1983, signed into law by President Reagan last April, will have an impact on the Department's Budget and important protection for the elderly in the near term and for years to come.

- These amendments placed the Social Security Trust Funds in a sound financial position by providing a total of $165 billion during the period 1983 through 1989 in added revenues or reduced expenditures.

- They also made a significant improvement in the way Medicare pays hospitals, replacing the inflationary cost-based reimbursement system with a prospective payment method. This major reform will encourage hospitals to be more cost-conscious and efficient, and will help to moderate the growth in Medicare expenditures.

During the past three years $7 billion in savings have been achieved in Medicare -- without reducing benefits to program beneficiaries. These changes were designed to preserve the Medicare program and maintain its viability.

In addition, recent changes in the law have allowed States much-needed flexibility to make their Medicaid programs more efficient. Using this authority, a number of States have launched interesting cost-effective innovations.

Yet Medicare and Medicaid are still expected to cost the Federal government 15 percent more this year than in Fiscal Year 1984. Our legislative proposals, I might add, would reduce this growth rate to 13 percent. We have seen overall inflation decline from 12.6 percent when this Administration took office to the present level of 3.2 percent. And, while I am pleased to note that health care inflation has declined in the past three years, these costs are still growing twice as fast as the general inflation rate.

The Department is updating its projections of Trust Fund status at this time, and more information will be available as part of the annual Trustees Report which will be available this Spring.

To assist in addressing this problem, the Department requested the Advisory Council on Social Security in 1982 to undertake an indepth review of this problem and to provide recommendations to preserve the integrity of the Medicare system. The Council's recommendations, which will be released soon, will be helpful in future consideration of solutions.

As we examine the reasons for Medicare's financial problems, one thing we should keep in mind is that in 1967, when Medicare started, the annual value of the benefits package for the average beneficiary was about $160. Today --due to enrichment of benefits and rising health care costs--the value of that package is over $2400.

In the coming year, the Department intends to work closely with the Congress, and with consumers and providers, to exchange views on this crucial issue.

I will review, just briefly, the proposals in our Fiscal Year 1985 Budget which are of interest to this Committee. A number of these legislative initiatives were first transmitted to Congress last year, and introduced by you, Mr. Chairman. Some of these proposals have been approved by this Committee and are included in the Omnibus Reconciliation Act of 1983, S. 2062, now pending before the Senate. Others were considered by the Committee as part of the Chairman's Budget Deficit Reduction initiative, just prior to the Congressional recess.

HEALTH PROPOSALS

Medicare Proposals

o Temporary Freeze on Physician Reimbursement

We are again proposing to temporarily limit Medicare reimbursement to physicians. Physician expenditures, the second largest component of Medicare spending, have been increasing by highly inflationary rates.

In 1983, physician expenditures increased 20 percent and are expected to rise 19 percent in 1984. We propose to allow no increase in the Medicare customary and prevailing charges for physician services for one year. The usual updating due on July 1, 1984 would be delayed until July 1, 1985 so that physician payment rates would not change. I would note that physicians were largely unaffected by the spending reductions enacted during the last three years.

This proposal would save the Medicare program $600 million in 1985.

o Medicare Part B Premium and Deductible

We are proposing modest increases in the part B premium and deductible.

When part B was first established, premiums paid by individual beneficiaries represented 50 percent of program costs. Over the years, premium increases have not kept pace with increased health care costs and, as a result, premiums now cover only 25 percent of program costs. We propose to move closer to the original balance between the premium and estimated costs by increasing the premium one and two-thirds percentage points each year for the next six years. By 1990, the premiums will be at a rate equal to 35 percent of estimated program costs. For Calendar Year 1985, the premium cost to the beneficiary would be $17.30 per month, an increase of just 40 cents more than the premium would be in 1985 under current law.

This proposal would increase Medicare premium income by $296 million in 1985.

We also propose to index the annual changes in the part B deductible to the annualized National Medicare Economic Index. This provision would help maintain the economic value of the deductible, which has been increased only twice since Medicare was established; from $50 to $60 in 1973, and to $75 in 1982. Current law does not provide for future increases in part B reimbursement between 1981 and 1984. Under this proposal, the deductible would increase by only $3, to $78 in 1985.

Indexing the part B deductible would save Medicare $40 million in 1985.

o Voluntary Voucher

The voluntary voucher program would expand opportunities for Medicare beneficiaries to use their health benefits to enroll in a wider array of private health plans as an alternative to traditional Medicare coverage.

In 1982, Congress, with the support of the Administration, amended the Medicare statute to permit payments on a risk basis to Health Maintenance Organizations (HMOs) and other competitive medical plans. The voluntary voucher program would build on this provision. Under this proposal Medicare would contribute an amount equal to 95 percent of what it would have cost to care for the beneficiary if he or she had elected traditional Medicare coverage. If a beneficiary selects a private health plan that costs less than Medicare's contribution, the beneficiary would qualify for a cash rebate. These plans would be required to provide a benefit package that is at least equivalent to that provided by Medicare.

While we do not project budget savings in the first year, we anticipate that this proposal will encourage health insurers, health maintenance organizations and other health care delivery systems to compete with each other for Medicare enrollees by keeping their costs down and by improving their benefit packages. It would also give beneficiaries an incentive to shop for the best buy and to choose a plan which best suits their individual needs.

The program would be entirely voluntary. Beneficiaries could chose to re-enter the Medicare system if they choose to do so.

o First Full Month of Eligibility

We propose to begin Medicare eligibility on the first day of the month once an individual reached age 65. Currently, Medicare eligibility begins on the first day of the month in which an individual reaches age 65.

This change should not result in a lapse of health insurance coverage because the large majority of individuals have private insurance which generally extends until the beginning of Medicare coverage.

This proposal is expected to save the Medicare program $265 million in 1985.

o Additional Medicare Proposals

Our Fiscal Year 85 Budget also includes Medicare proposals, previously submitted, which would:

—Provide that durable medical equipment provided through home health agencies be subject to deductible and coinsurance requirements. This would make reimbursement consistent for all medical equipment regardless of whether it is provided through a home health agency or an equipment supplier. Under current law the special full reimbursement for equipment furnished through home health agencies provides no incentive for appropriate utilization.

— Authorize volume purchasing arrangements for laboratory services, durable medical equipment and other medical supplies. Under this proposal beneficiary cost-sharing could also be reduced or waived.

— Increase the Secretary's flexibility in selecting Medicare contractors. This would give the Secretary authority to use a competitive bidding process to procure hospital claims processing services and to experiment with alternative contracting arrangements. This proposal would also permit contracts with intermediaries to be reimbursed on a basis other than cost.

— Eliminate the statutory requirement for a separate contractor to process Railroad Retirement Board Claims for part B services. Instead, we propose that these claims be processed by the same carriers that process Medicare claims. This would provide for a much more efficient payment operation.

-- Improve the Medicare payment system by authorizing HCFA to process provider claims as they are submitted. Under current provisions a second provider cannot be paid until a first provider's claim is settled. This proposal would simplify claims processing by eliminating the complex tracking system now necessary to assure sequential bill payment.

-- Repeal the requirement for End-Stage Renal Disease Coordinating Councils and Medical Review Boards. These organizations were created to monitor the quality of care provided to renal patients and to ensure the necessity of new or expanded renal facilities. The Department believes that these activities can be more efficiently carried out by other HCFA organizations.

These reforms would total $34 million of Medicare savings for FY 1985.

Medicaid Proposals

We are proposing several Medicaid initiatives designed to moderate the growth of that program to stimulate cost-consciousness and to make the program more efficient.

o Maintain Reductions in Federal Share of Medicaid

First, we are proposing to permanently extend, at 3 percent, the reduction in Federal Medicaid payments to States required by the 1981 Budget Reconciliation Act. States would have, as under current law, certain opportunities to moderate this reduction. Percentage point offsets would continue to be available to States with qualified hospital cost review programs, unemployment rates exceeding 150 percent of the national average, or fraud and abuse recoveries greater than one percent of Federal expenditures. In addition, States with expenditures below specific target amounts could earn back all, or part, of the reduction.

We believe that given the rate of growth in Medicaid -- currently estimated at 9 percent between FY 84 and FY 85 --removing these constraints would be counter-productive.

This proposal would save $567 million in 1985.

o Medicaid Cost Sharing

The Administration is again proposing a requirement for nominal copayments for Medicaid inpatient and outpatient services. We are proposing a $1 per visit copayment for the categorically needy (that is, all AFDC and most SSI recipients), and $1.50 per visit for the medically needy for physician, clinic, and hospital outpatient services. The categorically needy and the medically needy would also have a $1 and $2 copayment per day, respectively, for inpatient hospital services.

Medicaid's first-dollar insurance coverage leaves the beneficiary with no incentive to consider costs when seeking services and services that are free tend to be overutilized. Under this proposal we believe patients and their physicians will reduce the use of unnecessary services at only a very small cost to the beneficiary.

Requiring nominal cost sharing would save the Medicaid program $270 million.

o Improve Third Party Liability Collections

We also propose to mandate that States require Medicaid applicants to assign to the State their rights to medical support and third party payments for medical care.

This proposal would expand the ability of State Medicaid Agencies to become the payor of last resort and recover any health benefit payments due from other third party payors.

This proposal would save $7 million in Medicaid expenditures during 1985.

o Increase Medical Support from Absent Parents

Another Medicaid regulatory proposal to use third-party resources would require that state child support enforcement agencies seek medical support for clients. These agencies would also transmit information about medical support to the State Medicaid Agencies.

Health care made available through absent parents is expected to save the Medicaid program $100 million in 1985.

Maternal and Child Health

We are proposing a number of changes in the Title V authorizing legislation which will further enhance the ability of States to identify their own priorities and direct their resources to areas of greatest need. The proposals are a continuation of the block grant approach which provides maximum flexibility to States in their use of Federal funds.

We are proposing that the Federal set-aside of 10 to 15 percent of appropriated funds be eliminated. The funds now available under this set-aside are used to support services related to hemophilia and genetic diseases, special projects of regional or national significance, training, and research. We believe that the shift from a project grant approach to incorporation of the funds into the State Maternal and Child Health (MCH) block grants will enhance the ability of States to carry out their programs in accord with their needs and priorities. Research will be continued under existing authorities in the National Institutes of Health and National Center for Health Services Research.

Over the years it has become apparent that a large number of States are voluntarily devoting State and local funds to carrying out major MCH programs. Federal funds do not constitute a major portion of funding for maternal and child health activities. Therefore, we are proposing to delete the matching requirement which is currently in the law. Another proposed change would be to add language to allow State authorities to transfer up to 10 percent of MCH block funds to other HHS block grants. Current law permits funds to be transferred from other block grants into MCH but not the reverse. We believe that States should have the flexibility to transfer funds to meet their needs and that this should be restricted only in the sense that funds should not be transferred to an activity outside HHS purview.

Tax Treatment of Employer-Provided Health Benefits

A key component in the Administration's efforts to promote cost-consciousness is the proposed limit on tax-free private health insurance. The purpose of this proposal is to stimulate private plans to consider needed reforms in their own benefits and reimbursement rules. At present, all employer contributions to employee health benefits are tax-free to the employee and are treated as business expenses of the employer. We propose to limit this existing tax subsidy which encourages both parties to over-insure. Our proposal would allow tax-free treatment only up to $175 per month for family coverage, or $70 per month for individual coverage. Employer contributions above these amounts would be included in the employee's taxable income and be counted for Social Security tax and benefit purposes.

The tax cap would affect about 38 percent of those with employment-based health coverage. These individuals would remain free to purchase as much health care coverage as they desire but with "after tax" dollars. However, the cap would remove the inflationary inducement for the creation of excessive benefit plans.

Total Federal revenues in 1985 from this proposal will be $3.9 billion, of which $207 million will accrue to the Medicare Trust Fund, and an additional $873 million to the Social Security Trust Funds.

Our tax cap proposal is based on the common sense notion that the major cause of health cost inflation is the combination of broader insurance coverage and the lack of incentives on the part of employers and employees to select a low-cost insurance plan. It should stimulate competition among health care plans to keep costs down in order to keep premiums down. We believe that providing incentives for employees and employers to shop around for health care plans is preferable to the approach of imposing permanent cost-controls on hospitals and other providers that do nothing to diminish the underlying cause of health cost inflation.

OASDI TRUST FUND EXPENDITURES

The Department's budget reflects increased cash benefits of $11.6 million to be paid to retired and disabled workers and their dependents, and to survivors of deceased workers and their dependents, and to survivors of disabled workers from the OASDI Trust Funds.

The growth in expenditures from the OASDI trust funds primarily results from two factors: an increase of approximately 700,000 in the number of beneficiaries as more people reach retirement age and life expectancy increases; and automatic cost-of-living increases--3.5 percent just paid out in January 1984, and a projected 4.3 percent to be paid in January 1985.

SOCIAL SECURITY AMENDMENTS OF 1983

Last year the OASDI program was in severe financial difficulty with outgo exceeding income for both the long term and the near future. Passage of the Social Security Amendments of 1983 has restored the program to a sound financial position. In FY 1985 alone, the impact of this landmark legislation is to increase OASDI income by $9.8 billion, while reducing expenditures by $3.8 billion.

The 1983 Amendments established a "stabilizer" provision under which automatic annual benefit increases would be based on the lower of price or wage increases if the trust fund balance at the end of the prior year is less than 15 percent of outlays for the following year. (This 15 percent rate applies through 1988 and rises to 20 percent thereafter.)

TRUST FUND LEGISLATION

The FY 1985 budget does not include any legislation that affects Social Security benefits. As I have previously mentioned, it does reflect a health insurance proposal which taxes as income, health insurance premiums paid by an employer that are over a certain amount. Including additional interest earnings, this proposal would increase income and interest to the OASDI trust funds by $886 million in fiscal year 1985, and $10.2 billion through 1989.

The fiscal year 1985 budget does not propose any legislative changes in the Social Security disability program because we believe that the administrative and legislative reforms already accomplished make further legislative changes unnecessary. In addition, we believe that the very high costs of such legislation--the disability provisions of H.R. 4170 would cost up to six billion in the first five years--are unacceptable, especially at the present time when the safety margins of the OASDI trust funds are relatively small.

Moreover, I directed important administrative changes in June 1983 that are designed to make the program more responsive to the needs of beneficiaries while still assuring that we fulfill our obligations to Congress and the taxpaying public to administer the program in an efficient and effective manner. These changes include:

- A reduction in the number of beneficiaries to be reviewed every three years by expanding the definition of permanent disability. Now roughly 40 percent of disabled worker beneficiaries are exempt from the three-year review;

- Suspension of the review of two-thirds of the mentally impaired beneficiaries until the criteria for reviewing these cases are revised. Consultations have been held with the American Psychological Association, the American Psychiatric Association, the Consortium for Citizens with Developmental Disabilities, and the Mental Health Group (a coalition of experts in the mental health field), and a number of recommendations are expected shortly;

- Selection of cases for periodic review on a random basis. Random selection has eased the appeals case backlog and assured that the reviews do not disproportionately affect the mentally impaired;

- Beginning each continuing disability review with an interview in a local Social Security office;

- A thorough review of all disability policies and procedures in consultation with appropriate experts and the States.

However, we are continuing our top-to-bottom review of disability policies and procedures. We expect this review to result in additional improvements in the program that we can implement administratively. We are also in the process of implementing face-to-face evidentiary hearings at the reconsideration step of the appeals process. These hearings will improve the accuracy of decisions on continuing eligibility by ensuring that individuals have the opportunity to meet with the person deciding their case early in the appeals process.

We have notified the States to resume processing cessation cases beginning in February. Those States that are affected by court orders will process cases in accordance with the court orders. In the case of cessations effective in February, benefits will be payable for February and for two additional months. The last check will be paid May 3.

As in the past, we still support legislation to provide continued payment of benefits to a disability beneficiary who is appealing termination, through the <u>first</u> evidentiary hearing in the appeals process.

<u>AID TO FAMILIES WITH DEPENDENT CHILDREN</u>

Now let me turn to the Administration's major proposals for the Aid to Families for Dependent Children (AFDC) program. Our proposals, several of which were acted upon favorably by this Committee last year, would save $633 million dollars in FY 1985.

One of our major AFDC proposals strengthens current work requirements and improves the employability of recipients. The Administration believes that all able-bodied individuals who request assistance should be involved in some type of work-related activity from the day they apply. We propose that:

- All applicants who are able to work be required to begin searching for employment as soon as they apply for assistance;

- Those who cannot find employment must actively participate in a Community Work Experience Program (CWEP) of public or community services, or in a subsidized employment program, in order to increase their employability through actual work experience;

- Sanctions be applied against individuals who voluntarily terminate their employment or reduce their hours of employment without good cause; and

- States be permitted to require parents of children ages 3 to 6 to participate in work activities, provided child care is available.

- This standard set of work requirements would replace the Work Incentive (WIN) program and, consolidate responsibility for this activity in State welfare agencies.

Under the current statute, 36 States have implemented at least one of the work program options provided for under the Omnibus Budget Reconciliation Act and the Tax Equity and Fiscal Responsibility Act. Twenty-two States are operating

Community Work Experience Programs (CWEPs) and 10 States are operating Title IV-A employment search programs. In States which have implemented these programs, we are beginning to see very promising results with caseload reductions through both job placements and deterrence of those applicants who regard welfare as an alternative to work.

We are also proposing legislation to continue to better target assistance on those with the greatest need. We have several proposals to ensure that, in determining a family's need for assistance, all sources of income available to the family are considered. We propose to require that parents and minor siblings (except SSI recipients) living with an AFDC child be included in the assistance unit. This requirement, which was supported by this Committee last year, would eliminate inequities created when families exclude members with income from the assistance unit in order to maximize welfare benefits and would recognize that primary responsibility for support resides within the immediate family and not with the government.

Also as part of the process of defining the AFDC assistance unit, we propose to discontinue assistance to an employable parent or other caretaker relative when the youngest AFDC recipient is 16. Another of our proopsals which this Committee adopted last year is that minor caretaker relatives who have never been married be eligible for assistance, with certain exceptions, only if they reside with their parents.

Another proposal would require States to adjust the portion of the AFDC grant allocated for shelter and utilities for any assistance unit sharing a household with others.

In summary, our AFDC budget proposals build on the progress we have made through the Omnibus Budget Reconciliation Act and the Tax Equity and Fiscal Responsibility Act towards achieving true welfare reform. These proposals, together with the changes made over the last three years, further promote self-sufficiency and strengthen family responsibility.

SUPPLEMENTAL SECURITY INCOME

Under the Supplemental Security Income (SSI) program we expect to spend $9.3 billion in fiscal year 1985, compared with $8.6 billion in fiscal year 1984. Much of this increase results from the fact that, because of the way payment dates fall, there are 11 months of benefit payments in 1984 and 12 in 1985. In addition, the request include a cost-of-living adjustment of 4.3 percent effective January 1985.

The budget also includes savings of $16 million from two SSI legislative proposals allowing cross-program recovery of overpayments between SSI and OASDI.

CHILD SUPPORT ENFORCEMENT

The Department's budget incorporates the Administration's proposals to strengthen the Child Support Enforcement Program which the Committee is currently considering. These proposals are designed to strengthen the Federal-State efforts to ensure that child support obligations are enforced for all families.

We have proposed that the Congress enact legislation which would mandate that States have enforcement techniques that have been proven effective: mandatory wage withholding when an arrearage occurs, expedited judicial procedures to establish and enforce support obligations, and State income tax refund offsets for AFDC beneficiaries beginning in fiscal year 1985. These proposals are estimated to save $11 million in the Federal share of State and local costs; an additional $16 million would be saved from increased collections. Adoption of these proosals will also help millions of children obtain the support they need to stay out of poverty.

It is especially important that this Committee approve a requirement that States institute expedited judicial procedures. Currently, child support enforcement efforts are seriously hampered by delays in the court system, particularly in large urban jurisdictions. Families and children often have to wait from three months to two years for a court hearing. The practice of diverting child support cases to judge surrogates, such as we have recommended, has proven effective in reducing court delays.

In the State of Delaware for example, child support cases are being heard in three weeks whereas they would be delayed at least six months if judges were required to hear them. Also in one large Colorado county a support hearing before a referee usually occurs within one week while a hearing before a judge takes a month or longer.

In order to provide explicit incentives for State child support enforcement agencies to collect for both AFDC families and non-AFDC families, and to promote more cost-effective programs, the Administration's proposal would revise program financing. The current incentives of 12 percent of AFDC collections would be replaced by incentives of a minimum of four percent of AFDC and non-AFDC collections, up to a maximum of 10 percent, depending upon the cost-effectiveness of the State program. Non-AFDC incentive payments could not exceed a State's AFDC incentive payments. The Federal matching rate would be reduced from 70 percent to 65 percent. These changes do not decrease Federal financial contributions to this program, and provide greater emphasis on funding based on improved performance. In order to allow sufficient time for a smooth transition to the new system these changes would become effective in fiscal year 1986.

Our proposal would also require States to collect an application fee for services to non-AFDC families, and a collection fee would be charged to absent parents who fail to pay their support obligations on a timely basis after all arrearages have been collected. These fees would offset administrative costs, saving the Federal government $36 million in FY 1985.

Also, we support the House proposal to establish a special fund of $15 million annually to support projects designed to increase interstate collections. With this $15 million increase, and projections of an administrative cost increase of $13 million due to an expanded non-AFDC caseload and cost avoidance savings of $7 million (because child support collections help families to avoid welfare), total Federal savings from our proposals in FY 1985 would be an estimated $42 million.

SOCIAL AND COMMUNITY SERVICES BLOCK GRANTS

The Social Services Block Grant (SSBG) provides funds to States for a wide variety of social services, including day care, protective services for adults and children, and employment services. The basic principle of this program is that decisions on use of funds are best made by State and local governments who know the needs of the people they serve. The program affords each State the flexibility to control its own programs. To the extent possible, it does not burden State administration with procedural rules or paper work, but instead allows the States to set their own priorities and procedures for delivering services. We continue to propose a legislative change that will allow direct funding of Indian tribes.

The budget request for FY 1985 for the SSBG is $2.7 billion, which is the full appropriated entitlement level. In addition, to permit maximum coordination at the State and local levels between social and community services activities, we propose that States be allowed to fund under the SSBG those activities now funded by the Community Services Block Grant (CSBG) for which authority also exists under the SSBG. No funding is requested for the CSBG in FY 1985 which currently limits State flexibility by requiring that 90 percent of funding be directed to grantees that were funded in 1981. We believe that the CSBG program duplicates in large measure programs being funded under the SSBG and other HHS programs, such as the Low Income Home Energy Assistance Block Grant and programs of the Departments of Agriculture, Labor, Commerce and Housing and Urban Development.

FOSTER CARE/CHILD WELFARE SERVICES/ADOPTION ASSISTANCE

The Family Social Services programs provide direct services to children whose problems make it difficult for them to remain in their own homes. Child Welfare Services provide support to keep families together, to reunify children with their families or where this is not possible, to find adoptive homes for them. The Foster Care program provides funds to States to assist in the costs of foster care maintenance for eligible children and for administrative costs toward managing the program and providing training for the staff. The Adoption Assistance program provides funds to States to assist in paying maintenance costs for special needs children who have been adopted under this program. The major emphasis during the past three years has been to assist the States in implementing the new program requirements contained in the Adoption Assistance and Child Welfare Act of 1980 (P.L. 96-272).

The budget request for these programs for FY 1985 is $642 million, a $28 million increase over current FY 1984 levels. That includes $169 million for Child Welfare Services and Training, $13 million for Adoption Assistance, and $460 million for Foster Care. In addition, we are requesting an FY 1984 supplemental appropriation of $38.3 million for foster care prior year claims and $4.9 million for FY 1984 Adoption Assistance payments.

We are proposing that the separate authority for Child Welfare Training be repealed and the funds and authority for training be included in the grants to States under Child Welfare Services. We also will be proposing legislation to modify the Foster Care program to further promote the permanent placement of children who are currently in the foster care system. The precise details of the proposal are being developed for your review now.

Conclusion

The fiscal year 1985 budget and legislative program for the Department will continue to provide for essential services, while building on the accomplishments already made to restrain growth in spending. In 1985, the Department will continue to finance improved health and human services and will provide direct benefits to nearly one in every four Americans.

This is the first budget I have wholly presided over as Secretary of Health and Human Services. It is a renewal of my commitment to be a catalyst for caring and to be fiscally responsible to the American taxpayer.

Secretary HECKLER. Mr. Chairman, and members of the committee, I am pleased to be here this morning to discuss key aspects of our 1985 budget. The proposed budget for the Department of Health and Human Services is both caring and responsible: Caring for this Department's vulnerable constituencies who need our help; and responsible to the Nation's taxpayers who pay the bill.

To understand this budget, it is important to realize just how big it actually is. In 1985, the Health and Human Services budget will be $318.1 billion, a $22 billion increase over this year. The entire Federal budget did not reach the $300 billion mark until 1975.

Under this budget, HHS will spend more than $36 million an hour in benefits for more than 60 million Americans. Directly or indirectly, it will touch and benefit nearly everyone.

Consider what inflation means to the HHS budget. Every 1 percent increase in inflation costs my Department an additional $1.9 billion. This administration's success in bringing down inflation has saved HHS—and the American taxpayer—billions of dollars for each and every year inflation has declined. In 1985 alone, we will spend approximately $37 billion less than we would have spent if the 1981 inflation rate had continued unabated. Lower inflation means that every HHS dollar—in benefits, in services, and purchasing power—is worth more to those who receive our assistance. And we have actually computed in the Department that, had the 1981 inflation rate persisted through 1985, the increase on an hourly basis just due to that one factor would have been $4 million an hour.

Nearly 96 percent of this budget will be spent on entitlement programs which are mandated by and deeply embedded in our national law. These programs—social security and medicare foremost among them—are critical to America's ever increasing elderly population.

To maintain the integrity of these programs, we have worked to restrain our spending growth and to reform programs. Our budget increase for 1985 will be 7.4 percent, a significant decrease from the 17.7 percent increase in 1981. We have reduced that growth rate despite the fact that we serve more beneficiaries every year.

Reforms in social security, medicare, and other programs have produced important savings during the last 3 years. The new entitlement reforms we propose in this budget will reduce the deficit by $4 billion in 1985, and by more than $41 billion over the next 5 years. These kinds of reforms enable us to restrain spending even as more Americans are served. In 1985, 700,000 more elderly beneficiaries will be served.

In medicare, with the cooperation of the Congress, we have taken an important step forward by implementing one of the most cost-effective changes in history—the prospective payment system. For the first time, the U.S. Government will become a prudent buyer of health care services by telling hospitals beforehand what we will pay for a certain treatment, techniques, and other services. It is a system which will reward efficiency and penalize wasteful practices, while preserving the quality of our health care.

But you and I both know, Mr. Chairman, that prospective payment isn't enough to deal with the ballooning costs of our health entitlements.

Medicare and medicaid continue to grow rapidly, at a rate of almost 15 percent a year in medicare and 9 percent a year in medicaid. They are expected to reach nearly $92 billion—29 percent of HHS outlays—in 1985. The cost of both programs has escalated rapidly from $20 billion in 1975 to $46 billion in 1980, and has almost doubled since then. By 1989, under current law, these outlays are estimated to be $143 billion.

While estimated savings of $7 billion have been achieved in medicare over the last 3 years, additional action is needed to restrain these rapidly rising costs and preserve the integrity of the hospital insurance trust fund. Thus, the 1985 budget includes a number of legislative proposals which affect medicare and medicaid. And in general these will not be new to the committee. These changes include, for medicare:

Holding payments to physicians to 1984 levels for 1 year.

Limiting open-ended tax subsidies of relatively high cost private health plans.

Expanding opportunities for medicare beneficiaries to enroll in private health plans.

Gradually increasing the premium for the optional part B program so that enrollees by 1990 will pay 35 percent of the program's cost—the original medicare legislation established the enrollees' share at 50 percent; currently beneficiaries pay 25 percent; in addition, the cost of the part B deductible, currently a fixed dollar amount, would be increased in future years consistent with the Medicare Economic Index.

For medicaid, we propose maintaining limits on reimbursements to States, and instituting modest cost-sharing measures for recipients.

If the Congress enacts the medicaid and medicare proposals in the President's budget, savings through 1989 in the Department's budget would be $35 billion. Moreover, revenue to the Treasury general fund would increase by another $29 billion through the taxing of private health plans, which I mentioned previously.

In this budget, we continue our efforts to refocus the aid to families with dependent children program to serve the neediest families. Since our first reforms were enacted 2 years ago, 31 States have increased the benefit levels for AFDC families. These increases and the increased purchasing power due to reduced inflation have had the effect of raising the average benefit by over $50 per month—for the direct benefit of children most in need.

AFDC budget outlays are projected at $7.1 billion; our request includes a number of legislative proposals designed to strengthen work requirements and opportunities and to target our resources to those most in need.

These proposals would save more than $600 million in AFDC and $230 million in medicaid in 1985. Through 1989, savings would total $6.3 billion in both programs.

The elderly, of course, are one of the most important constituencies of this Department, and with this budget, older Americans can look ahead with confidence. They now have a social security system built on a sound financial foundation, and, because of this, we are able to provide the full scheduled cost of living increase in benefits.

In 1985, social security retirement and disability outlays will increase by $11.5 billion. This increase is accounted for by an increase in the number of beneficiaries; a higher average benefit amount due to higher earnings of newer beneficiaries; and the annual cost-of-living increase, estimated at 4.3 percent payable in January 1985. This increase in outlays is more than offset by increases in income to the trust funds of $22.5 billion.

Obviously, I am keenly aware of the committee's continuing interest in the disability insurance program. At present, we are implementing face-to-face hearings for those undergoing a continuing disability review. The Social Security Administration has made vital changes to improve this review process in the last year. Further improvements are occurring as a result of the reforms, which I announced in June 1983.

These are:

A reduction in the number of beneficiaries to be reviewed every 3 years by expanding the definition of permanent disability. Now roughly 40 percent of the disabled worker beneficiaries are exempt from the 3-year review.

Suspension of the review of two-thirds of the mentally impaired beneficiaries until criteria for reviewing these cases are revised. Consultations have been held with the American Psychological Association, the American Psychiatric Association, the Consortium for Citizens with Developmental Disabilities, and the Mental Health Group, a coalition of experts in the mental health field. A number of recommendations for my consideration are expected shortly. I have met personally with the leaders of the coalition, and I'm impressed with their competence and commitment to the work product.

Selection of cases for periodic review on a random basis. Random selection has eased the appeals case backlog and assured that the reviews do not disproportionately affect the mentally impaired.

Beginning each continuing disability review with an interview at the local social security office.

A thorough review of all disability policies and procedures in consultation with appropriate experts and the States.

Moreover, the Administration continues to support legislation to continue payment of benefits through the first face-to-face evidentiary hearing.

We believe that these steps have improved the disability program and that the improvement will continue. I'm committed to these improvements while protecting the financial integrity of the disability trust fund.

Finally, as you mentioned in your earlier reference, Mr. Chairman, we propose a new and aggressive child support enforcement program, which we discussed with the committee on January 24. When absent parents are forced to pay support owed legally to their children, these children and their families become less dependent on the local, State, and Federal governments for help. When parents support their children, my Department is better able to target its resources, rather than increase its spending. Our proposals would save the Federal Government $152 million through 1989, but at the same time result in increased child support collections and a far more effective program.

I would say, Mr. Chairman, that since this is the first budget in which I have been involved since becoming Secretary of Health and Human Services, that I would like to renew my commitment to be a catalyst for caring and to be fiscally responsible to the American taxpayer.

Now this concludes my short statement, Mr. Chairman, and I would be very happy to respond to your comments and questions.

The CHAIRMAN. Thank you very much. We follow the early bird rule. Since I was here first, I will begin.

I understand you are planning to work with the Governors, State legislators, and others to build upon any child support enforcement legislation enacted by the Congress. Could you elaborate on your plans? I assume you intend to get them. They should take a more active role in enforcement.

Secretary HECKLER. Exactly. We feel that it's terribly important to create a priority and a sense of urgency about the problem of child support enforcement. The Department has data indicating that in 1983 the unpaid amount due the children of America, was in the area of $4 billion. And I feel that unless we have a commitment on the part of the Governors, merely having a new process created through legislation will not necessarily achieve the desired results. And, conversely, a Governor's sense of priority can make the success of the program a reality. It really is as simple as that.

As you know, our proposal mandates three legislative changes, first it would require the mandatory wage assignment, which has been the most effective tool for the collection of child support in every State. In New York City alone when mandatory wage assignment was applied, the collections increased from 40 to 80 percent.

We favor a quasi-judicial fast track system for enforcement orders and for the enforcement process, because almost all of the urban courts in the country have such a backlog that the custodial parent and children are not only penalized by the delay in payment, they are also penalized by the court backlog. A quasi-judicial process can speed that up—accelerate the process.

And I feel also that the existence of the 90/10 matching money for computerization will allow States that feel ready to do so to impose a new electronic data processing system, and really make child support enforcement almost an automated activity of State government.

But all of these things take the commitment of a Governor to the program, the support of the legislature, and presume, of course, the support of the Congress in passing the legislation—which we do expect. Hopefully we will resolve our differences on that.

We feel very strongly about bringing in all of the separate elements of a truly effective national strategy, and I think the Governors are pivotal. I intend to meet with the Governors' Association. I have spoken to many of the Governors. They are creating a task force on it. It's not just a question of the money that we can save for American taxpayers. The effect of our bill will go beyond welfare families and into the collection of support for nonwelfare families. It is a question of what is right for the children of America. I think we have a very aggressive strategy outlined.

The CHAIRMAN. Well, I hope the Governors might get involved in paying for more of the program too. They are very good at writing pieces about the Federal deficit and the need to reduce it. But I'm frankly concerned that the child support enforcement financing provisions are too liberal now. I can understand why the States would be interested in maintaining the current financing—the 90 percent for computers and the 70 percent for administrative expenditures—plus incentives payments. It's a great thing for the States. It just means that the Federal Government have assumed the financial responsibility to collect child support. Now, it is a good program. But I would hope that the Governors, in addition to asking for more money, might be able to help us tighten up some of the costs of the program.

Again, I recall a couple of weeks ago in the Washington Post there was a great article by two Republican Governors and two Democratic Governors scolding the Federal Government for the big deficit. Yet I have never had the Governors' Association come before this committee and ask for less. And it seems to me that they can't have it both ways. The deficit is everyone's problem. They all have cash basis logs or constitutional amendments so they can't have a debt, so they come in here and increase ours.

So the Governors are going to be in town in 2 or 3 weeks and we hope to have a chance to visit with them on this issue. They are all nice people.

Another area in the child support enforcement program—we've heard from some groups representing fathers who say you ought to require visitation as a condition of payment. It seems to me that that is going to be fairly difficult to do. As I understand, the thrust of this program should help the children.

Secretary HECKLER. That's right.

The CHAIRMAN. Do you share that view? That's another area we have to wrestle with.

Secretary HECKLER. I feel very strongly about it. I'm very sympathetic to the fathers who are requesting visitation rights and certainly feel that this should be worked out. But I think that we cannot in the Federal Government despite our support for this program, cannot take the place of the domestic law court. We cannot make arrangements between the parties and intervene in that way. What we are talking about in this program is providing a process for financial support; whether or not a child sees his father or the father has the appropriate visitation rights is a subject that I think the domestic law courts in the local jurisdiction must handle.

The issue we want to resolve, however, is the parent's commitment to the financial well-being of the child, and you don't need to have intricate and sensitive negotiations on that subject. This is an issue that can be resolved based on income and need. And once the order is decreed, any adjustments can be altered or modified under this quasi-judicial process. But I feel that we cannot enact a Federal law that creates any uniformity, because the circumstances are too individual and unique.

The CHAIRMAN. Well, I think that's the general view of the committee. But I know it's a problem for many fathers who are denied visitation rights for probably no good reason. It's a good reason if they are not paying their child support. And I assume that when they start paying their child support, visitation may take care of itself.

I just have one additional question for now. Last year the administration sent us a proposal to restructure beneficiary cost sharing and provide catastrophic coverage. That was not in this year's package. And I assume there was a reason for it.

Secretary HECKLER. Yes; that's right. The reason, Mr. Chairman, is simply that since the submission of last year's proposals, we have begun implementing the prospective payment system. And this system is designed by virtue of its fiscal discipline alone to create more efficient utilization of hospital resources and facilities. One of the purposes of the earlier copayment proposal was to create better utilization patterns.

We feel, at this point, it behooves us to look at how the prospective payment system is being implemented and what effects it has before considering another major change in medicare. We feel that prospective payment should be given a chance to work itself out and to be assessed thoughtfully before a major restructuring of medicare is proposed.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. One of the things in your budget that makes a rather large difference with respect to the numbers you are presenting to us, are the assumptions that you use in calculating the savings produced by the continuing disability review process for the disability insurance program. A little background on the program is, of course, that it is an insurance program. And it is separately funded. There is a tax rate that is allocated to it. And, indeed, the tax rate has varied since 1970 anywhere between 0.55 percent of taxable payroll to a high of 0.825 percent of taxable payroll. The tax rate has, since 1978, been cut three times so that it is at now an all time low since 1970 of 0.5 percent of taxable payroll. It is scheduled to rise in 1988 immediately after the Reagan administration leaves office after its second term to 0.53 percent, then 0.60 percent and 0.71 percent—and the Heckler administration at HHS, we assume.

Secretary HECKLER. Thank you for that.

Senator HEINZ. The program, unlike the Social Security Trust Fund or OASI, as we call it, has always run a surplus. Indeed, its surplus today is the best surplus it has had since 1975. It is running currently a $6.9 billion trust fund balance, a significant amount of money.

One of the projections that you make for this program is based upon certain assumptions. I am told that the projections of your budget are founded upon the assumption that there will be no moratoria on the continuing reviews will be imposed, either by the States, or by the courts. Currently, some 26 States have one form or another of restrictions or moratoria on this process today.

My question is: Are your budget numbers realistic if, indeed, there are these large number of court and State imposed moratoria in existence?

Secretary HECKLER. We feel that our budget figures will stand up. We also realize that the issue has been the subject of congressional consideration, and that a bill has been proposed. But our budget figures assume that the moratoria will end within about 2 years, and that is a built in assumption of the budget. In terms of the process itself we also feel that there will be stronger State support of the process by virtue of the changes that I announced in June. The implementation of the changes has only begun; some changes take effect at the local level in January of this year as a very extensive training process has had to take place.

Senator HEINZ. There are two questions, of course. One is whether your assumption that all these moratoria are simply going to disappear, that the courts are going to reverse themselves, that the Governors are going to do as you are asking them right now to end all moratoria—whether that is going to happen.

Now if that doesn't happen, if things just stay exactly as they are 2 years from now, how much will that increase your expenditures?

Secretary HECKLER. I'm sorry, Senator. We will have to supply that figure for the record.

Senator HEINZ. All right.

Secretary HECKLER. But I would say that I am somewhat more optimistic about the outlook.

Senator HEINZ. I'm sure you are. But without getting into that question, I just want to get some numbers.

Secretary HECKLER. Yes. We would be happy to provide those.

Senator HEINZ. And you don't have to agree this is going to happen but I'm just saying an alternative event is that one of these cases will reach the Supreme Court.

Secretary HECKLER. Yes.

Senator HEINZ. And at that point the Supreme Court could rule that Congress intended a medical improvement standard, and that SSA has not been consistent with that, and, therefore, in effect you get a nationwide moratorium de facto by the use of the medical improvement standard. How much would that cost? How much would that increase outlays over the next several years?

Secretary HECKLER. Senator, we would be happy to provide all of those figures for the record.

[The information from Secretary Heckler follows:]

No estimate is available of the administrative and program costs which would be expected in the absence of congressional or Executive Branch action if courts continue to impose medical improvement standards and if States with self-imposed moratoria do not resume processing termination cases.

The SSA Office of the Actuary considered this issue in connection with preparing cost estimates for recently proposed disability legislation and assumed that the effects of unfavorable court decisions and State-initiated moratoria would phase out over a period of 2 to 3 years. If a longer phase-out had been assumed, the costs associated with present law would of course have been higher, and the costs associated with the legislation would have been correspondingly lower. At the extreme, if it had been assumed that disability decisions in all States would eventually be affected by either court decisions or State moratoria, some or all of the costs associated with the application of a medical-improvement standard would be shifted from the various bills to present law. SSA cannot estimate the costs of such uncertain events with very much precision, primarily because no implementation-policy decisions could have been made involving court decisions that have not occurred and State moratoria that have not been imposed. Until a decision can be obtained from the U.S. Supreme Court on the medical improvement issue (1985 at the earliest), the various district and circuit courts could impose (and some already have imposed) varying standards. The State moratoria also differ in their scope and effect.

However, if the Supreme Court were eventually to rule that SSA should apply a medical-improvement standard before terminating benefits to disabled persons, the costs associated with that decision would be similar to the costs associated with the medical—improvement provisions of the various bills currently being considered. The exact costs would depend on several factors—for example, whether the standard would have to be applied to past terminations, and whether various exceptions would be provided from the standard to cover situations involving fraud, failure to cooperate, a beneficiary currently engaging in substantial gainful activity, etc.

Senator HEINZ. I would appreciate that.

I am informed by the social security actuaries in a letter dated February 3 that if we assumed that the disability decisions in all States are eventually affected by either court decisions or State moratoria, some or all of the costs associated with the application of medical improvement standard would be shifted from the various bills we were asking to be analyzed to present law. In effect, proposed legislation such as Congressman Pickle has proposed would become effective through court action. And under those circumstances, there would be substantial additional costs to HHS.

Secretary HECKLER. Yes.

Senator HEINZ. And we would like to see those numbers.

Secretary HECKLER. Our figure on that is about $4 billion in increased OASDI benefit payments. And that has been already estimated by HHS and is included in that February 3 letter.

Senator HEINZ. I am a little troubled by something. Before you became Secretary, Senator Dole, Senator Levin, Senator Cohen, myself, Senator Metzenbaum, and Senator Durenberger met with Dick Schweiker. And this was in August 1982. At that meeting he pledged the administration to negotiate with those of us in the Congress to construct a mutually acceptable comprehensive reform bill. It was assumed that that legislation would include some kind of a medical improvement standard. Nothing happened on that. There were some procedural reforms implemented by HHS consequent to that, but no substantial reform.

You became Secretary in 1983. You met with Senators Dole, Levin and Cohen, and my understanding—I wasn't at that meeting—was that you pledged the administration would support a compromise reform package that would include some form of a medical improvement standard. Is that right so far?

Secretary HECKLER. No, it isn't. I would just simply like to say I'm not at all aware of the meeting with Secretary Schweiker.

Senator HEINZ. I understand that.

Secretary HECKLER. I never heard of that.

Senator HEINZ. The last question, though, was regarding your October meeting with Senators Levin, Cohen, and Dole.

Secretary HECKLER. I did attend a meeting very briefly with Senators Levin, Cohen, Dole, and staff from the various offices, including mine. And the area of concern was the search for a common consensus, but without any preconditioned pledge that there would be such. It was simply an exploratory session, as I understand it. And because of another engagement, I had to leave. But there was no commitment made on my part concerning that.

Senator HEINZ. Was there any commitment made to engage in serious negotiations to develop a compromise?

Secretary HECKLER. A commitment to explore subjects of concern.

Senator HEINZ. What happened as a result of that?

Secretary HECKLER. Well, we explored some of those subjects and discussed them. And we also discussed what could be done. But I think that it is totally inaccurate to say that I at any time made any commitment. I never did.

Senator HEINZ. But there was a commitment to negotiate a solution.

Secretary HECKLER. I don't believe that—it depends on what one considers the negotiating process. It was a commitment to consider the subject and explore the issue.

Senator HEINZ. When did the negotiations end?

Secretary HECKLER. There were no negotiations of which I know, Senator. They were shared discussions.

Senator HEINZ. They were short.

My time has expired. Thank you.

The CHAIRMAN. Go ahead.

Secretary HECKLER. I simply would like to say we believe that, as a result of internal reforms that we have undertaken in the Department, while certain changes might be considered in terms of the process itself, we already have instituted what I think is a system that will truly provide fair, humane, equitable, responsive reviews of not only hearings, but every single case. The standard of fairness will be met.

And I would also say that all of this became an issue before the Congress, while I was a Member of Congress. The GAO in its report circulated in 1980, preceded by internal discussions with the Department that I have learned about, showed that there were very serious errors in monitoring and review. And they assessed the abuses of the program to be in the vicinity of $2 billion, or 20 percent of the recipients.

The Congress responded; it required perodic review; and the Department undertook it. I was critical of the way in which that review was conducted. I want to say that. I was very critical of it. When I became the Secretary, I did review the process and institute a top to bottom review and changes for humanizing the process.

This process is now being implemented. We have trained the State employees who will conduct the review process in a face to face reconsideration, an evidentiary reconsideration hearing. We believe that all of these steps will achieve the basic goals of the legislation, which were to provide equitable benefits for those truly disabled under the standards of the statute; and, second, to review cases on a timely basis with fairness and equity as the only standards. We feel we have achieved that type of process, and have totally reformed the system. And under those circumstances, we question whether or not a further standard should be imposed by the Congress. In fact, we very much disagree with such a standard.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Madam Secretary, I would like to direct my remarks to medicare. If nothing is done, what is your prediction as to when the system will go broke?

Secretary HECKLER. Well, the actuaries seem to be conflicting in their views.

Senator CHAFEE. I mean they just can't pay their bills. I know it's probably broke now as far an income versus outgo. But drawing on all your reserves and everything, when won't they be able to pay their bill?

Secretary HECKLER. At this point, Senator, the actuaries in our department are reassessing the state of the economy and their basic assumptions, and we will submit a report this spring. But as you know, I am sure, the CBO, had earlier estimated the bankruptcy and the size of the deficit in the system to be in the area of $300 to $400 billion by 1995. CBO has reexamined its assumptions and produced a different set of scenarios. Our Department is now assessing and reviewing their approach as well as our own and when we submit our annual social security trustees' report, we will have our final actuarial assumptions and our forecast.

But there's no question about the fact of insolvency. It's a question of the time, the timeframe, the exact year.

Senator CHAFEE. I think we all agree, don't we, that it's very close, the insolvency of the medicare fund. I don't know where the suggestion of 1990 goes. Did you say CBO was suggesting 1995?

Secretary HECKLER. Well, no, that's for a very, very substantial deficit of $300 to $400 billion, its earlier estimate.

Senator CHAFEE. But I suspect that within 2 or 3 years the fund will be insolvent. It's insolvent now, but I mean unable to pay its bills.

Secretary HECKLER. Well, 1990 is the figure that is most often suggested.

Senator CHAFEE. Well, the thing that bothers me is that I'm not sure that the proposals that you have submitted are really going to solve the problem. And I, for one, am prepared to make the efforts that should be made to solve this. But I think there is a danger in nickel and diming at it because then if you keep doing this, you undermine the public's confidence as to whether we are really solving it, whether we are serious. And these proposals that you have made here for the so-called reform, I think you will agree are not going to do the trick. Is that correct?

Secretary HECKLER. Senator, we never suggested that they would do the whole job. We do feel that our prospective payment system, which the Congress passed——

Senator CHAFEE. Well, no one would argue with the prospective payment. That's wonderful. That has been done. Everybody has been saying it should have been done, and it was done. And I congratulate you for that. And that's a real achievement that is going to help.

But I mean the proposals you made on page 4 of your testimony—"gradually increasing the premium for part B up to 35 percent or having increasing the deductible, indexing it, with the medicare economic index." But are you telling me now that those will not solve the problem?

Secretary HECKLER. By no means. Senator, I would just simply say that I feel at the moment we have to certainly consider the recommendations that the Schweiker Advisory Council will advance to the Department.

Senator CHAFEE. When will those be?

Secretary HECKLER. I would expect by the end of the month.

Senator CHAFEE. Now are those meant to solve the problem?

Secretary HECKLER. Yes; these are proposals that are designed to deal with the insolvency issue and to deal with it on a broad based approach. At the same time, I would say that I believe we need to have a very substantial debate in the country. The last thing I want is for a problem as important as the medicare program solvency—a program which is basic to the health of our elderly Americans—the last thing I want is to have this become a political football.

Senator CHAFEE. No one is suggesting that. We are not taking this in a political context. I'm trying to find a solution to this.

Secretary HECKLER. Well, I am too.

Senator CHAFEE. And get your suggestions. Now what do you think of advancing as it were piecemeal when it is not a comprehensive attack on the problem? In other words, as I see this this is a massive challenge. It involves everybody. It involves the providers. It involves the third party payers. It involves the beneficiaries, the physicians, everybody. And I think we should do it. If we had an answer, I would take it. But if you go ahead and say now we will increase the beneficiary's charges under part B to 35 percent, when really to solve it might take 50 percent, which as you say in your testimony was the original goal, do you think that initiates our possibility of solving the problem in the end?

Secretary HECKLER. I would simply say that, first of all, the problem does exist and it is serious. But the size, the magnitude of the problem, has been reassessed by the Congressional Budget Office, for example. And contrary to the earlier projection of a deficit amounting to about $300 billion by the year 1995, the CBO now estimates by that same year the deficit would be in the range of $95 to $125 billion.

Now these are still staggering numbers. At the same time, what would be a reasonable approach for one would not necessarily be required for another.

Senator CHAFEE. I think we had better be very cautious in accepting a lower figure on anything. Everything we have done around here has turned out to be more expensive than we originally anticipated. And it's great comfort to take the CBO projection of, what, $300 billion——

Secretary HECKLER. 300 billion.

Senator CHAFEE [continuing]. And scale it down to 90 and saying the problem isn't so severe. I don't agree with that. I think to be safe we better look on the up side of the CBO estimate rather than taking some down side.

Well, I notice my time is up. I would like to return to this later.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Madam Secretary, the budget for HHS for 1985, as you point out in your testimony, is $318 billion. Just looking at the budget, of that $318 billion, $261 billion is in social security, disability insurance or medicare.

Secretary HECKLER. Yes.

Senator DANFORTH. And that means that $57 billion is for everything else.

Secretary HECKLER. Exactly.

Senator DANFORTH. Now in 1981-82 when we were going through the process of trying to get the spending side of the budget down, we pretty well combed over those nontitlement parts of the HHS budget. And I notice in the increases from 1983 to 1985 there has been very little increase, virtually no increase in those nonentitlement areas. The increases have come in the entitlements. That is in 1983 outlays were entitlements were $222 billion, in 1984 $240 billion, 1985 $261 billion. In other words, the lion share of the HHS budget is entitlements. And that has been the growing part of the budget. And the nonentitlement part of the HHS budget has been pretty well combed over and has been held constant during the last 3 years. Am I right so far?

Secretary HECKLER. Exactly. In fact, the entitlement share has been gradually moving upward and it is now at 96 percent of the budget. And while I will say that through enormous programmatic reforms we are doing more with less. For example, in the congregate meals area, we are serving many, many more meals than before, and through the voluntary contribution of some of the beneficiaries, we are able to continue to expand services without expanding the Federal cost. The fact is that we still have only 4 percent of the budget for discretionary programs so you are absolutely right.

Senator DANFORTH. Now, again, looking at the budget, the revenue side of the budget for 1985, $328 billion is in individual income taxes so that the total amount that the Federal Government is taking in in individual income taxes is $328 billion, and the total HHS budget is 318, or just $10 billion less than what we are taking in in income tax.

I am not going to ask the administration to look down the road to next year except to ask you if it is fair to say that if we are going to try to reduce the size of the deficit, HHS must be a part of the picture, and that the nonentitlement part of the HHS budget has been trimmed pretty much already.

Secretary HECKLER. I think that when you look at a budget of $318 billion, 96 percent of which is consumed by entitlement programs, you find there is a crowding out of discretionary programs. And we have seen that the discretionary programs have been leveled, as you have said.

The fact is that looking at a deficit, I'm sure that across the board all of these questions will have to be raised. But I feel very strongly that we have to understand the special commitment we have to social security, which has been reformed by the bipartisan Greenspan Commission (National Commission on Social Security Reform), and the essential nature of the medicare program. And while I would agree with Senator Chafee, who is conservative in his estimates, I would take that approach too, and await the actuarial assumptions of my own Department.

Nonetheless, I think it's quite clear that the medicare problem alone will require a bipartisan, rational approach, dealing with the essence of the program and the protection of it, while looking at other responses on how to make it financially feasible.

Senator DANFORTH. I have here a transcript of a radio program that was on national public radio several weeks ago, and the broadcaster was Mr. Crulwich. And the person who was kind of the counterpoint in the program was Pete Peterson, the former Secretary of Commerce. And one thing that Peterson says in the program is as follows: 13 percent of the Federal budget went to the elderly in 1960. Twenty-five percent to the elderly in 1980. Thirtyfive percent will go to the elderly in the year 2000. And 65 percent will go to the elderly in the year 2025.

Do you know what the basis of that is? And do you have any way of telling us whether that is anywhere near correct or not?

Secretary HECKLER. I really don't know what assumption he has used, but, obviously, the demographics and the graying of the country, certainly the graying of the population, are obvious. This year, 700,000 more elderly Americans went on the social security rolls. Now the fact is that the estimates in our Department in terms of the percentage of HHS outlays, in 1985, benefiting the elderly, are 68.1 percent. That is $216,686 million. Obviously we are beyond the two-thirds point in expenditures benefiting the elderly in this Department. Looking at demographics, one can project that perhaps into the figures that Mr. Peterson has recited. I haven't seen those.

Senator DANFORTH. I wonder if you could give us for the record what your counter to the Peterson statement is. Could you do that?

Secretary HECKLER. You are looking for the percentages of the total Federal budget?

Senator DANFORTH. I'm sure that a lot of this is based on estimates and who knows where he got these figures. I think that he had some sort of study group that looked into it. But if this kind of change is happening, we should at least know about it. Maybe it's right. I mean maybe this is what we want to do.

Secretary HECKLER. Well, Senator, I will say we will certainly comply to the best of our ability. I know that we can give you projections of elderly programs based on our existing data for the Department of HHS. I don't know that we could do it for the whole Government.

Senator DANFORTH. If you could just comment on it. And maybe you could check with OMB or somebody.

Secretary HECKLER. We would be glad to.

Senator DANFORTH. In other words, apples and apples on his conclusions. And he also says in another part of the program—and what he is talking about is his concern that there is really going to be a generational conflict in our country between people who are on the work force and people who are retired. Peterson says "When our kids discover that the fund of the social security system alone by the time they retire will cost 25 or 30 or 35 percent or 40 percent of pay * * *" I mean I don't know if this is right or not. It just seems awfully, awfully high to me. But if it is right, I think that the least we should do is to have our eyes open.

Secretary HECKLER. Absolutely.

Senator DANFORTH. So would you be good enough to just comment on that for the record?

Secretary HECKLER. I would be very happy to, Senator. I will send you the projections from the Department with our comments.

Senator DANFORTH. Thank you very much.

[The information from Secretary Heckler follows:]

The Office of Management and Budget does not establish economic assumptions or budget projects more than four years beyond the year of the President's Budget Request. In the case of the fiscal year 1985 President Budget estimates for this Department, and for the Federal Budget as a whole, have been made only through fiscal year 1989. Given this, we cannot with confidence estimate what percentage of the Federal budget will be devoted to the elderly in the year 2000 or 2025. However, I can tell you the following:

1. We estimate that 27.8 percent of Federal outlays will be spent for the elderly in fiscal year 1985 and 29.0 percent in fiscal year 1989.

2. The Social Security Trustees report estimates that total Old Age, Survivors and Disability Insurance (OASDI) trust fund outlays will grow from $191.3 billion in fiscal year 1985 to $459.7 billion in the year 2000 and $2,570.8 billion in the year 2025. These estimates are based on the Trustees' intermediate alternative II-B which is the less optimistic of the two intermediate alternatives used by the Trustees. Given changing demographic factors, however, I would hesitate to make an estimate of the percent of these total outlays that will benefit the elderly.

Several points should be considered in evaluating Mr. Peterson's statement that the cost of the Social Security system in the future could be a source of generational conflict between workers and retirees. The first point concerns the costs themselves. Mr. Peterson suggests that the cost of the Social Security system will reach "25 or 30 or 35 percent or 40 percent of pay . . . ." In fact, under the intermediate II-B assumptions in the just released 1984 Trustees Report, the cost of the old-age, survivors and disability insurance (OASDI) program is projected to reach a maximum at the end of the 75-year projection period (2060) of 15.45 percent of taxable payroll. Only under the "pessimistic" economic and demographic assumptions in the Trustees Report would the cost of OASDI reach the bottom end of the range Mr. Peterson suggests.

A second important point concerns the cost of the Medicare hospital insurance (HI) program, which is also financed through payroll taxes. As you know, the HI program was enacted in 1965 and its cost has escalated dramatically since that time, in large part because of consistently increasing unit costs and utilization rates in the health field. Because so many factors affect health costs and because health care costs have proven to be so difficult to control, cost projections for the HI program are considerably more uncertain than those for OASDI. Because of this uncertainty, long-range cost estimates for the HI program have generally been made only for a 25-year period.

Although the 1984 Trustees Report includes a 75-year cost estimate for HI, it uses the II-B assumptions developed for OASDI and then assumes that HI unit costs increase at the same rate as wages increase after the first 25 years. The estimates produced using this procedure indicate that the cost of the HI program will more than triple by 2055—increasing from 2.71 percent of payroll in 1984 to 9.46 percent by the end of the period.

The relevance of long-range HI cost estimates based on the provisions of present law is questionable, however, since the Trustees Report shows that without remedial legislation the HI program will run out of money in the next decade. Although the escalation of health care costs is clearly an issue that we will all have to face, there is not yet any clear consensus about the means to resolve it. Until basic decisions about HI program and financing reforms are agreed upon and the actuarial soundness of the HI trust fund is restored, it is altogether misleading to draw any inferences about future HI payroll tax rates from current long-range projections of HI program costs.

A final but very important point in terms of any potential for generational conflict in the years ahead, is that OASDI and HI benefits do not go just to aged people. For example, only people under age 65 are eligible for disability benefits and associated HI benefits. Moreover, nonaged survivors of deceased workers and dependents of disabled and retired workers also receive Social Security benefits. Currently, about 17 percent of OASDI benefit dollars are received by people in nonaged categories of beneficiaries, who constitute about 20 percent of the OASDI rolls.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman.

Madam Secretary, what is the Department's position on recalibrating DRG's before 1986? Suppose there is clear evidence that a specific DRG might be out of line. I've come across such a specific situation recently in Marshalltown, a community of about 40,000, 50 miles from Des Moines, Iowa, our largest city in the State. The payment differential between the two cities can be illustrated by an example: a DRG which would pay the Marshalltown hospital $1,000 would pay a Des Moines hospital $1,600. Referring back to the DRG recalibration issue, it happens that in the Marshalltown Hospital an overwhelming amount of their business is for cataract surgery, with the use of an intraocular lens, a procedure undervalued in the relevant DRG. So the Marshalltown Hospital is being hurt twice by the new system.

But more important than that is the fact that there is a difference of 60 percent in just a 50-mile radius. Would you address both questions, the general one and the more specific issue?

Secretary HECKLER. The fact is, Senator, that the Prospective Payment Commission will be reviewing the regulations and impact and will advise the Department.

But I will say from your description of the problem, it may be a case in which the DRG system is not the problem; it's the question of the urban, rural rate distinction. That however, relates to a system imposed by OMB governmentwide which classifies areas based on certain factors, and determines what constitutes an urban or rural area. And our DRG rate is pegged to the OMB classification system so that the urban, rural mix is pegged to this governmentwide system. And I think that's the core of your problem, one, I think, that has come to the Department before.

Senator GRASSLEY. Regardless of its history, it still has an inordinate impact on some hospitals.

Secretary HECKLER. Yes, sir.

Senator GRASSLEY. Whatever the problem is, it remains a system that we have legislated regardless of its statistical base. It would seem to me that we have to do something about it before 1986.

Secretary HECKLER. Well, we, in the Department, are studying the issue, and we have received considerable correspondence on the question. We do have the difficulty of the so-called "MSA system" that OMB has imposed, and with legitimate reasons.

At the same time, the impact on prospective payment has caused a very strong response in some areas. So the Department is looking at this. We also will expect the advisory commission to make recommendations on this issue.

Senator GRASSLEY. That answers my specific question about a problem with a certain DRG, even if the problem lies in the statistical base. What about the more general question? Do you expect any recalibration of DRG's before 1986?

Secretary HECKLER. Well at the moment we are discussing with the hospital industry a wage adjustment for rural hospitals. So that is one of the potential areas of change.

Senator GRASSLEY. So you feel like you are on top of these problems?

Secretary HECKLER. We are extremely aware of the problems, and we are exploring avenues of approach, and what the equitable response would be. We are on top of the problem. I don't say we have the answers yet.

Senator GRASSLEY. I have one final general question. The bulk of your Department's 1985 budget requests parallel those of 1984. Considering the lack of success in obtaining support for those changes last year, could you tell me anything significant or different that you are doing to generate the necessary support this go-around as compared to the last year?

Secretary HECKLER. Well, there are some, I think, significant differences in the legislative submission that we have made this year. For example, the absence of the medicare copayment and catastrophic illness proposals. We feel that the prospective payment system should be monitored and implemented fully before we undertake a resubmission of that. So that's a very, very substantial change.

However, we also feel, for example, that in the area of the tax cap on health insurance benefits, the cost consciousness of corporate America has increased substantially. The value of these programs and the need to be disciplined and cost-conscious in terms of health insurance and its affect on inflation and health care cost, is a subject that has received more attention this year than last.

But what we really hope to do is work very, very closely with the committee and your staff to try to achieve the reforms that we have proposed this year. They have been scaled down from last year's submission, and we feel this is more realistic—but very, very necessary. And we hope that this kind of a close working relationship can make the difference in terms of dealing with cost problems.

Senator GRASSLEY. I thank you, Madam Secretary.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

Good morning, Madam Secretary. Nice to have you here. I apologize that I missed your formal presentation, but I will carefully go through it.

I would just like to echo what Senator Grassley said about the problem between urban and rural classification. We really have that very severely in Coeur d'Alene, Idaho, with the relationship that it has to Spokane, Wash., and in the Boise Valley. I hope that we can get some—from what you commented, what can I tell those hospital administrators in the Nampa-Caldwell area who compete for all the services with the Boise area but have a differential in the payment? Is this going to be resolved soon?

Secretary HECKLER. Well, first of all, the differential is related to the designation of the area as being urban or rural according to the MSA system that has been imposed governmentwide by OMB. So this classification system has been effective in other areas and in other Government programs. The problem with the DRG's is related to the fact that the classification of a geographic area has been set by OMB.

What we are looking at is the question of potentially changing the wedge indexes. And we are working with the hospital industry on that basis.

Senator SYMMS. Maybe you should take the lowest common denominator and that would save money.

Secretary HECKLER. Well, we are also living with the budget neutrality requirement.

Senator SYMMS. My constituents didn't think that was the way they wanted to go.

Secretary HECKLER. Well, we understand the problem, and we hear you.

Senator SYMMS. Well, it is a problem. But I think that a bigger problem that you have—and that I think we have to have everybody involved in this solution because I personally don't believe that we can just simply solve this problem without having the patience involved in the part of the equation, which, I know, is part of your philosophy. They have to pay more money up front, in my opinion, in order to make people cost conscious or we will bankrupt the country just in medicare alone in another 25 years or it won't take that long. What was said? The 35 percent of our GNP that Senator Danforth made the point about. That will be consumed for health care in a very short few years. And I don't think the country can afford that.

So, I was a little disappointed that the cost sharing proposals of last year were left out. You commented on that briefly. Maybe you have already stated it.

Secretary HECKLER. Well, the basic reason they weren't included in this year's submission is simply that we have implemented the whole prospective payment system this year. And one of the goals of prospective payment is to reward efficiency on the part of hospitals and to create better utilization. One of the goals of a copayment proposal was also to decrease utilization, to make it effective and necessary. We feel that we are probably achieving some of that through the prospective payment system.

But I also feel that in looking at the other proposals we saw that you have to realize what the Congress will pass and what the mood of the Congress is. And, frankly, we have tried to be realistic. We are pushing for some reforms that have not fared well in Congress because we think they are necessary. But I think in looking at the broader question—medicare solvency—we have to look at this in a very careful, rational way, bringing in the effect of constituencies on a bipartisan basis. And I think—as we await the report of the Advisory Council appointed by former Secretary Schweiker—we should consider its recommendations and then listen to others before a final resolution of dealing with the great and serious problem of medicare is actually proposed by the executive branch and finalized by the Congress.

I think it's terribly important to have a broad-based and bipartisan approach—removed from politics.

Senator SYMMS. Well, I wish you good cheer on that and good luck. I think what we have to recognize is that with over 50 percent of the people paying more social security taxes than they pay incomes taxes that it's not going to set very well with people just to try to solve this problem by raising taxes. That we are going to have to have cost sharing. We are going to have patient participation on the up front side to really resolve the question. I don't see any other alternative myself, and I hope that we can achieve some of those things. I wish we could do it now. And, I, personally, am ready to do it now. But it may not be the mood of the Congress yet.

But I think the longer we put these things off, the harder it is.

And we thank you, Mr. Chairman. I would ask unanimous consent to insert in the record at the proper place my statement.

The CHAIRMAN. Let me say that you and Senator Grassley touched on a point that has also been noted in other rural States. And we are trying to figure out something with HHS and the Census Bureau and OMB and others. We've met with some Kansas hospital administrators who called that to our attention a couple of weeks ago. So, we are working on it.

I was just looking in the economic report, the part that some, I guess, would throw away. But it says in 1984 we are going to collect $293 billion in income tax, which wouldn't even be enough to take care of your agency because you are looking at, what, $318?

Secretary HECKLER. In 1985 we are looking at $318 billion.

The CHAIRMAN. I guess in 1985 we collect 328 from individuals. And that would be enough.

Secretary HECKLER. Right.

The CHAIRMAN. But we also collect $270 billion in social insurance taxes and contributions, which primarily fund your programs. But, again it's an indication we have got a real problem. And I don't know what the answer is, but I hope that the "downpayment" group will meet soon. It would be very helpful.

Secretary HECKLER. I agree with you.

The CHAIRMAN. It has been called to my attention that in the President's budget, in the appropriation request for medicaid, aid to families with dependent children, child support enforcement, and child welfare services, you have included substantive language which would accomplish your legislative objectives without bothering to have the proposals acted on by the Finance Committee. Can you explain why this approach has been followed? In other words, we are bypassed.

Secretary HECKLER. I have been informed that this is a Government-wide policy by OMB to put the legislative proposals before the Congress in this way. It's not an initiative of HHS.

The CHAIRMAN. Well, maybe we ought to work out something with OMB then. Abolition type——

[Laughter.]

The CHAIRMAN. We kind of like our work here. We meet everyday and we would hate to be bypassed. Where do their budget requests go? [Laughter.]

Secretary HECKLER. You have that ultimate weapon, you know.

The CHAIRMAN. I will speak to Martin Feldstein about this. [Laughter.]

I think many of the questions I have have been answered. And we may submit some questions in writing.

I understand that you do propose to continue the reduction in Federal medicaid matching payments and continue to allow the States to offset these amounts. How many States were able to offset reductions over the last 2 years? If that is a detail that you don't have, you can furnish it.

Secretary HECKLER. In fiscal year 1982, 26 States had no net reduction. In fiscal year 1983, 13 States had no net reduction. That is, they recovered all the reductions taken. In fiscal year 1984, 11 States are estimated to have no net reduction. So I could submit for the record the specific State list.

The CHAIRMAN. Right. I think that's some information that we would like to have.

[The information from Secretary Heckler follows:]

INSERT FOR THE RECORD
ORBA REDUCTIONS BY STATE

For FY 1982, 26 States had no net reduction. In other words, these States recovered all of the reductions taken. For FY 1983, 13 States had no net reduction. For FY 1984, 11 States are estimated to have no net reduction.

The specific States with no net impact were:

	FY 1982	FY 1983	FY 1984
Alabama	-	x	-
Alaska	x	-	-
Arkansas	x	x	-
California	x	x	x
Delaware	x	x	-
Dist. of Col.	x	-	-
Georgia	x	x	x
Idaho	x	-	x
Illinois	x	x	x
Kansas	x	-	x
Kentucky	x	-	-
Maryland	x	-	-
Massachusetts	-	-	x
Michigan	x	-	-
Missouri	x	x	-
Montana	x	-	-
New Hampshire	x	x	-
New Jersey	x	-	-
North Carolina	x	-	-
Okahoma	x	x	-
Oregon	x	-	x
South Carolina	x	x	-
Tennessee	x	x	x
Texas	x	-	x
Vermont	x	-	-
Washington	x	x	x
West Virginia	x	-	-
Wisconsin	x	x	x
Total	26	13	11

The CHAIRMAN. And I also understand that the part B premium proposals submitted last year contained a hold harmless. That an individual's social security check wouldn't be reduced when their premiums increased. Is that in this year's proposal?

Secretary HECKLER. Yes, Senator.

The CHAIRMAN. And I guess you probably have statistics. Can you provide us with an estimate as to how many individuals would, while not suffering a loss, receive little or no cost-of-living increase as a result of this change?

Secretary HECKLER. Yes. We will provide that for the record, Senator.

[The information from Secretary Heckler follows:]

INSERT FOR THE RECORD
PREMIUM INCREASE HOLD HARMLESS

The Part B premium proposal contains a hold harmless provision so that an individual's Social Security check won't be reduced when their premiums increase. Can you provide us with an estimate as to how many individuals would, while not suffering a loss, receive little or no cost of living increase as a result of this change?

A very rough estimate is that 50,000 or fewer beneficiaries would be protected by the hold harmless provision and have no reduction in their cash payment due to the premium increase.

- The latest estimate of the premium that will be effective on January 1, 1985, is $17.30*, an increase of $2.70 per month ($32.40 for the year) over the current $14.60 premium. Few Medicare beneficiaries have smaller Social Security cash increases. It is not possible to estimate how many individuals would receive little or no cost of living increase as a result of this change.

- Using the 4.3 percent cost of living increase projected for January 1985 cash benefits, a beneficiary would have to have a net monthly Social Security benefit of $63** or less in order for the premium increase to completely offset the cost of living adjustment.

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* The proposed law premium of $17.30 is based on the assumption that all other Part B proposals are enacted. If no other Part B proposals are enacted, the premium for 1985 would rise to $18.00, an increase over the current $14.60 premium of $3.40 per month, or $40.80 for the year.

** $79 or less if the premium increases to $18.00 per month.

The CHAIRMAN. I will just say—and I will then yield to Senator Heinz—that we believe that we can accomplish the savings you recommend, maybe even more, in this committee. I think there's a general bipartisan concern about matters we have jurisdiction over. Tomorrow we have Mr. Grace coming to talk about the Grace Commission. I'm not certain that we will tax welfare benefits, as he suggests. But there are some provisions of his report that I assume we might find some savings. Are you in the process now of reviewing the Grace Commission report?

Secretary HECKLER. Yes, we are, Mr. Chairman. We have made some recommendations in the Department. And, in fact, I have imposed a freeze on hiring so that we would protect the existing workers as we looked at the Grace Commission recommendations. I will say that some, of course, are, in my judgment, more suitable than others.

They have suggested a very broad based closing of Social Security offices, which I don't believe would be wise policy in dealing with the needs of the elderly. But I do feel that many of their proposals are very worthwhile and we are undertaking a review and implementation of some of them.

The CHAIRMAN. It would be helpful if you would give us your conclusions because what we are looking at, obviously, are those matters we have jurisdiction over. I must say the biggest chunk, I think, would be taxation of benefits, which is probably not going to happen. I don't think that's realistic.

But, again, we ought to hear out Mr. Grace and his commission. And maybe we can find a few nuggets in there somewhere.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

I want to return briefly to disability and then I have one other question of an unrelated matter. When we ran over time, you were saying that the GAO in 1980 determined that there were about 20 percent of the people on the disability rolls that shouldn't be on there. And that were they to be stricken, the Department would save about $2 billion. Could you tell us what percentage the Department, in fact, has succeeded in removing from the rolls, and how much that has saved?

Secretary HECKLER. The figure I have received most recently is that actually for reviews through December 1983 after all of the appeals issues have been resolved, the net expected to be removed from the rolls turns out to be incredibly close to the GAO estimate with a savings of $1.1 billion.

Senator HEINZ. My information is somewhat different. And, indeed, when Commissioner Martha McSteen was here she gave some very different numbers to the committee. My numbers in terms of the number of people who are being stricken from the rolls is close to 45 percent.

Secretary HECKLER. No.

Senator HEINZ. It is true that two-thirds of the people who appeal the decision of Social Security do get reinstated. This is nothing, however, to be very proud about because they are told that if they are one of the unlucky one out of three who lose their appeals, they will have to, if they claim the benefits through the appeals process, pay it all back within 30 days.

I guess the question I have got for you is this: You have made some changes in the review process. How are they going to help in a case such as the following; namely, a constituent of mine named Richard Carter from Belle Vernon, Pa.

He went on the disability rolls in 1979. He was terminated after review of his continuing eligibility in May of 1982, before you came on board. In June of 1982, he requested an administrative law judge hearing, which has yet to occur. Three treating psychiatrists have verified that he is schizophrenic and manic depressive. Last week he was committed to the Jefferson Psychiatric Ward. And he has a previous history of institutionalization. He has periodic outbreaks of violent behavior. His psychiatrists suggest involuntary commitment as that he is in danger to himself and to society. He is incapable of handling personal finances. In fact, he spends all his and his family's funds on superfluous items. He gave away all of his fuel for the winter.

Now despite the recommendations of his treating psychiatrists, Carter was removed from the rolls by the Greensburg office, Greensburg, Pa. In Greensburg there are no qualified psychiatrists or psychologists. And Carter was evaluated by a general practitioner.

My question is: Does anything we are doing help someone who clearly was stricken prior to your moratorium on the mentally disabled? What are we doing to help these people who were wrongfully thrown off the rolls? And there are tens of thousands of them, I suspect. How do they get their due? This is an insurance program. Everybody who is eligible for this has paid money into it. It is not a give-away program. It's not welfare. How do we help this person get a standard of fairness and equity, which you say you are pledged to?

Secretary HECKLER. Oh, absolutely. And I think that it sounds like an enormously deserving case. And it's exactly the kind of case that I am working on at the moment.

I have to say that in terms of your earlier statistics, I have been briefed extensively by acting Commmissioner Martha McSteen and by our disability program specialists and that 45-percent figure you cite, was the number of cessations before appeal in 1982 divided by the number of reviews at the initial level. The net figure is 23 percent. That is after appeal.

But my concern, and a part of the changes that I announced in June, was to address the problem, for example, that we did not have psychiatrists available to assess mental impairment. There was a need to review the categories, and make the new mental illness regulations of the disability program, consistent in terms of the state of the art. So that I announced at that time that we would hold in abeyance these serious cases of mental impairment, and that I would undertake a consultative process with the American Psychiatric Institution, the American Psychological Institution, et cetera. Now we have done that.

Senator HEINZ. And we commend you on that. You have followed through on that.

Secretary HECKLER. We have. And in the very near future they are going to send me a set of regulations. I said also that when a new set of standards has been established by the Department, then

I intend to review those who have been terminated because of mental impairment who would fall within these categories, because I am concerned that there are those who had not been treated fairly. And this was part of my announcement in June.

Senator HEINZ. This fellow was cut off the rolls in May 1982. It is now February 1984. In some months you are going to have some standards, which, if you find this fellow, might help him. In the meantime, Lord knows what is happening to him.

Now I'm glad we are getting new standards. It is long overdue. I hope they are good standards. I understand they should be reasonable. But what you have also said is that this fellow who has been hanging out there for more than a year and a half is going to have to hang out there some more. And there are a lot of people like him, aren't there?

Secretary HECKLER. I would hope not, Senator. But let me just say this, and this is a quote from my statement in June:

> Once we have acceptable standards, I will authorize going back to re-review those who may have been dropped from the rolls in the past under existing standards and this relates to functional psychotic disorders.

As I became aware of this problem, we did institute a comprehensive review of the situation. The American Psychiatric Association assured us yesterday through their representative, that it will have psychiatrists available for consultation at the local offices, so that problem of having a less than knowledgeable doctor review the situation will not occur.

For the individuals affected by the mistakes of the past, I can really only say that I am enormously sympathetic, and I hope to address this in the changes that we are going to promulgate based upon recommendations from this group.

Now I would like to say, Senator, that I certainly would be interested in looking into any of the specific cases that you have. I have already ordered a review of the case load by the Office of Disability to separate out those who might fall—within the categories of mental impairment that would warrant the re-review. So, that, SSA is now working on that project.

But beyond that, we would certainly want to address any single individual cases, any number of them. Truly, I can't be more sympathetic.

Senator HEINZ. One last question. Different subject. Social HMO's. Your Department is charged with the responsibility of approving the waivers by the States to establish these. A number of us have a great deal of interest in that because we were told, as I recollect, by Larry O'Day when he testified up here that before certain other decisions could be made about the advisability and cost of integrating funding sources and services for persons eligible for both medicare and medicaid that it would be extremely helpful and perhaps even necessary to get the experience from these social HMO's.

My understanding is that you are having some problems with other parts of the administration. Is the Office of Management and Budget a problem to you?

Secretary HECKLER. I'm afraid it is. I think there is something of a difference of opinion here. We are in consultation with them.

There are certain segments of the demonstration design submitted to them with which they do not agree. Our staff is discussing this with them. We do strongly support the social HMO's. And we are doing everything possible to reach agreement and expect a resolution shortly.

Senator HEINZ. We want to encourage you to do that. We don't want you to be run by another branch of government, a fourth branch called OMB.

Secretary HECKLER. I find it quite onerous myself.

Senator HEINZ. And I think you will find a lot of support on the committee for your position.

Secretary HECKLER. Thank you. I have to say, Senator, that they have not been at the helm. I want to assure you of that. We do negotiate our differences.

The CHAIRMAN. I understand there may be a meeting tomorrow on this very issue between somebody and somebody. That's progress. [Laughter.]

Senator HEINZ. I'm sure that's probably true, too. [Laughter.]

The CHAIRMAN. As I understand, you have an 11:30 appointment. With that in mind, are there more questions? Senator Chafee.

Senator CHAFEE. Madam Secretary, going back to the medicare quickly, the quandry that I opposed was that by proceeding this year in a series of modest steps that are not going to solve the problem are we jeopardizing, in your judgment, the chances of making some real solutions? What is your recommendation?

Secretary HECKLER. Well, Senator, just briefly I would say that first of all the financing problem is becoming better known. There are differences of opinion on magnitude, but the problem exists. Second, I recall the Chinese saying a journey of a thousand miles begins with the first step. So the first steps that we are proposing—and some of our proposals are not baby steps, but some are very small—they are necessary and worthwhile. But I think that we cannot suggest draconian measures without first knowing the dimensions of the problem; second, draconian measures are not the right way to approach a very serious problem that deals with the rights, the needs of a substantial and important segment of our population. I feel very strongly that we have to create a climate in which rational, fair, bipartisan debate is advanced, and all factors taken into account, and one in which the elderly are participants in the process. This is something that, frankly, in this election year, given my knowledge of the Congress and past experience in it, I feel is simply not a do-able proposition at this time. Nor are we ready, because we haven't even received the report from the commission that my predecessor, Secretary Schweiker, set up.

Senator CHAFEE. Is that the Bowen Commission?

Secretary HECKLER. Yes.

Senator CHAFEE. When is that going to be ready?

Secretary HECKLER. I think in March.

Senator CHAFEE. Oh, it will be in March. Well, I'm not going to dispute the position you take on this. My only concern is that this is a massive problem. I think you are right in that it must be approached. We've got to know the dimensions of it. We've got to really deal with everybody who participates in it because it is going to be draconian when we finish. The solution is not going to be simple. It's not going to be a solution which the beneficiaries aren't going to be required to do something. I think we recognize that.

Secretary HECKLER. Well, Senator, I would hope it will not——

Senator CHAFEE. It's nice to say, oh, you get it from the doctors or you get it from prospective reimbursement, but it's far deeper than that.

Secretary HECKLER. Yes. Well, I would agree that it's a serious problem. I would hope the solutions would not be draconian on the beneficiaries. I think we have to realize how vulnerable they really are. I think that we have to look at options that will provide solutions that are fair for everyone.

Senator CHAFEE. Well, let's use a different word than "draconian," then, whatever that means. It is going to be difficult. Let's put it that way.

My time is up, but I'm going to ask you one quick question. Last year we had a proposal, one of these modest steps which was delay the participation of the person in medicare until the end of the month in which his or her birthday occurred. I, for one, expressed great concern that some people would fall through the cracks that way, that they would not have the adequate coverage in the interim. Is it my understanding that you have done some studies on that as to how many beneficiaries will be unable to close the gap due to their private coverage from their employers and so forth?

Secretary HECKLER. Right. We have done some research on this subject. And all our data show that 84 percent of the individuals involved in the relevant year had private health insurance. Sixty-nine percent work-related; 31 percent nonwork related. Eight percent had public coverage through medicaid, medicare or through Champus. And 8 percent had no insurance at all. But what you are talking about—we have resubmitted that proposal.

Senator CHAFEE. So if they didn't have it, they——

Secretary HECKLER. They never had it at all. That's right. They had nothing before.

Senator CHAFEE. So the question is can they tiptoe through this.

Secretary HECKLER. Fifteen days or whatever. It could be that or it could be 30 days or whatever.

Senator CHAFEE. All right. Fine. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

I would just ask as you leave—we are still meeting at certain stages on the disability problem. It is a serious problem. There is a rather wide divergence of views, even on this committee. I had to leave the room during your discussion with Senator Heinz, but I assume you have representatives who are willing to discuss at a staff level where we think we are, where we think we may have to go. We are getting to the point where we are going to have to do something.

Secretary HECKLER. Mr. Chairman, I want you to know that we are very concerned about disability. And I feel that it is incumbent upon everyone who has an interest in the subject to review the important steps we have taken. We have truly rewritten the process, created a face-to-face meeting for the initial consideration of the case from the outset, which never occurred before. The reason that so many mistakes were made and sad cases occurred was because the review process was a paper process. And I, as a Congresswoman, had constituents who were affected who deserved to be on the rolls. And if they had been seen just by one person, they would have been automatically continued. There was never that opportunity until the ALJ level. Now we have instituted two face-to-face exchanges. One at the outset, and one at the reconsideration level in the State. And we have been training workers all over the country for the new system which went into effect January 1 of this year.

Also, we have sent out a series of circulars describing in enormous detail our standards. And I personally intend to issue a further statement of policy to provide that the review be humane, fair, equitable, and responsive. We are requiring a review of the medical records of the individual for the preceding year. And in the mentally impaired cases, we are doing a very special review, as I have mentioned.

Now all of these things, I am absolutely confident, will create a climate in which fairness will be achieved and the truly disabled will receive what they deserve. The continuances will occur from the outset.

But the point to be made is this.

The GAO in its study of the issue—in 1980—circulated a draft report citing the $2 billion in excess ineligible that had been made under the old system. The GAO estimated a 20-percent error rate, 20-percent ineligible rate or whatever you wish to call it.

We find that after the ALJ level, the net cessation rate is 23 percent—about 8 percent of the workers in the rolls in March 1981.

We are also totally revamping the system comprehensively from beginning to end on a personal and humanized basis that will be fair, effective, and responsive. Under those conditions and circumstances, I think imposing new burdens on the system, requiring new training processes, requiring a new burden of proof aside from what should be essential to fairness, is to further complicate a system that has been reviewed, reformed and is responsive.

But we are available, of course, to meet with you whenever you wish.

The CHAIRMAN. I appreciate the changes that have been made. I don't think there is any question about it. But like anything else, once you make some changes, then the people who wanted the changes made think of nine other changes that ought to be made. We have very good staff around here, and they have a lot of ideas. They are great ideas if they didn't cost so much money.

We do want to make certain that those who are disabled benefit from the program. And I must say there are a lot of pressures on me as chairman to move something. I think we have reached a point where if we can't do it in committee, we are going to have to go to the floor. If the medical improvement amendment passes, we may end up with a veto and then we'll see what happens on a veto. But, hopefully, we can hammer out some compromise that might satisfy the majority. If not, I think we may just have to proceed because there are a number of Senators who feel strongly that if we can't work it out, let's go to the Senate floor. And we would rather work it out. So, hopefully, we can start meeting again this week with HHS.

Secretary HECKLER. Well, we are at your disposal. We want to work with you. We would like you to take into account what has been done and our very substantial changes in this program. We feel that equity is going to be achieved, that there are some small changes that could be effected. But, basically, we have addressed the problem. What we want is fairness for the disabled, and fairness for the taxpayer. And I think that in trying to achieve both goals, which I think is possible, what we have done is probably as well designed, appropriate and available immediately to meet the needs of the program as anything that can be proposed.

The medical improvement issue is one that is complex. There are many different variations of the standard. It's difficult to address one. In the functionally psychotic area, for example, the psychiatrists were telling me yesterday that with new drugs a person can improve and appear to be improved and then really find that it's not a permanent improvement. And that in their judgment, the medical improvement standard per se would be of no value in this type of case.

So what we are looking at is equity. Is there disability? Is there medical evidence? What is the petitioner's evidence and so forth?

But we will be happy to work with you.

The CHAIRMAN. Thank you very much, and thanks for coming.

[Whereupon, at 11:38 a.m., the hearing was concluded.]

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