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TO: SENATOR DOLE

FROM: JOHN PETERSEN

RE: NATIONAL ASSOCIATION OF GOVERNMENT LABOR OFFICIALS

DATE: JANUARY 30, 1984

In checking with several individuals representing the above group, the following were identified as some of the key issues they would be discussing during their working sessions. All of the individuals I talked with indicated they wanted you to speak on the budget-deficits generally and did not expect you to necessarily comment specifically on the technical issues they would be discussing during their morning session.

Issues they are concerned about include:

1. Unemployment Compensation - Problems involving states that had to borrow huge sums from Federal Unemployment Trust Fund during the high unemployment periods. Alternative payback schedules are being investigated and discussed by the group.

2. Job Training Partnership Act - They will be discussing the various state experiences with the program to date. So far, all indications are that things are going smoothly, however, many states are still only in the organizational stage of the program.

3. Davis-Bacon Act - Labor has been upset with the Administration's latest change in the formula for determining the "prevailing wage". As you know, the Act dictates that a certain wage will be paid on federal projects, which in effect inhibits non-union companies from winning jobs through bid cutting. The change in formula allows for a lower "prevailing wage" to be utilized. The United State Supreme Court has recently refused to review a court decision which held that the Administration's rule is legal and is not unconstitutional.

For your information, this group consists primarily of state labor officials including state labor Commissioners. Also in attendance will be the regional labor directors for the U.S. Department of Labor.

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REMARKS OF SENATOR DOLE

NATIONAL ASSOCIATION OF GOVERNMENT LABOR OFFICIALS

Monday, January 30, 1984--12:00-2:00 p.m.--SH-321

What is the Federal deficit likely to be?

- The estimates of future Federal deficits are quite sensitive to one's economic assumptions. Yet even under the most optimistic of economic assumptions, the deficit will remain at historically high $200 billion levels over the foreseable future, unless drastic action is taken.

- Assuming an extremely strong recovery (4% real growth of GNP) is sustained over the next few years and all of the Administration's proposed spending cuts are made, the deficits are still projected to be:

FY 1985	FY 1986	FY 1987	FY 1988
$185 billion	$195 billion	$199 billion	$179 billion

- If economic growth is not so strong (3% real GNP growth) and interest rates are slightly higher (9% T-bill rate), and Administration's spending cuts are not enacted, the projects deficits would be:

FY 1985	FY 1986	FY 1987	FY 1988
$202.6 billion	$236.7 billion	$270 billion	$290.1 billion

- If we have an economic downturn during this period, we may be facing $300 plus billion deficits.

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

- If nothing is done to reduce deficit spending over the next five years, the total Federal debt will nearly double to over $10,000 for every man, woman and child in America.

- At this level, by 1989 it will take one-half of all Americans' personal income tax payments just to pay the Federal Government's interest bill.

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Israeli Free-Trade Area

- The Administration has proposed that a reciprocal duty-free arrangement be established with Israel. I will sponsor this for the President.
- A hearing is scheduled for February 6. The Textiles Coalition is scheduled to testify.
- Because our overwhelming trade advantage with Israel is threatened by a free-trade agreement between Israel and the E.C., this proposal is very important to U.S. trade interests.
- We will give serious consideration to an exemption for textiles.

DISC

- I have introduced a bill, S. 1804, which reflects the Administration's proposal to replace DISC with an entity which will be compatible with GATT rules.
- The new entity, called the Foreign Sales Corporation, will exempt a portion of the income generated by significant sales functions performed outside the U.S.
- A second hearing is scheduled for February 3.

Trade Reorganization

- A trade reorganization bill, S. 121, has been reported out of the Government Affairs Committee, and the Finance Committee will have hearings on this issue in February.
- In view of House opposition to trade reorganization, the Administration's proposal does not appear to be going anywhere.
- "Industrial Policy" amendments contained in the Senate trade reorganization bill will complicate Senate action on the bill.

Trade Law Reform-S. 2139

- There are a variety of proposals to reform our trade laws, streamlining the antidumping and countervailing duty procedures and responding to industrial targeting and so-called "upstream" subsidies.

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- We are likely to consider these issues in the Finance Committee once the House has had an opportunity to review and refine them. Congressman Gibbons will attempt to markup a bill very soon, perhaps on February 1.

- While important, trade law reform is very controversial in its specific aspects. It is too early to predict its prospects.

Domestic Content Bill

- I would anticipate an effort to pass domestic content legislation in the Senate in 1984.

- Although the bill passed the House, I anticipate substantial opposition to the bill in the Senate.

- I regard the bill as a dangerous and counterproductive idea which could inflict considerable damage on American exporters while providing transitory benefits to the auto industry and its workers.

Trade Deficit

- The U.S. merchandise trade deficit exceeded $60 billion last year and will be larger next year.

- This deficit is caused in major part by the over-valued dollar which in turn is a reaction to the high interest rates caused by the federal budget deficit.

- We are looking at ways of reducing the federal deficit, but we are considering calling hearings in the Finance Committee to see what else might be done to reduce this growing trade deficit.

LDC Debt

- The huge debts accumulated by less developed countries, particularly Mexico, Brazil and Argentina, is a major cloud hanging over the international trading system.

- These debtor countries have promoted exports and slashed imports in an effort to earn the foreign exchange needed to pay their debts.

- While most of the attention has been focused on the dangers of default, I believe we must also be concerned about the effects of LDC debts on our balance of trade.

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TALKING POINTS--DOWN PAYMENT ON THE DEFICIT IN 1984

- While the President is taking the lead to begin a deficit-reduction effort in 1984, beginning with modest spending reductions and tax reforms that will generate revenue. We should work from these proposals, and build on them, to enact a significant 'down payment' on the deficit in 1984. As the President indicated in his State of the Union address, we can reduce the deficit by $100 billion over three years with this approach.

- As the President indicated, even though election-year politics make it difficult to launch the kind of major assault on the deficit that we really need, that is no reason to do nothing. If we scale back our expectations somewhat, we should be able to make a noticeable dent in the deficit--and that will make our job easier in the years ahead. What is even more important, it will demonstrate to our citizens and to economic decision-makers in all sectors that we can face up to the deficit problem even in an election year.

- The bipartisan working group proposed by President Reagan can begin with a number of deficit-reduction proposals already on the table, some of them already in the legislative 'pipeline'.

  -Items included in the FY 1984 reconciliation bill, S. 2062, still pending in the Senate

  -Treasury-endorsed proposals on tax shelters and other abuses

  -Administration-proposed spending cuts that were not carried out last year

  In addition to these sources for ideas to cut the deficit, we can draw on proposals made by the Grace Commission, other proposals suggested to the Finance Committee last fall, and initiative recommended in the President's FY 1985 budget.

- Target: Last November the Finance Committee instructed its staff to prepare a deficit-reduction package totalling $150 billion. It may be more realistic at this time to aim for a total of $100 billion, divided 50-50 between spending cuts and revenue increases.

- Feasibility: This seems to be reasonable, 'doable' goal to set if you consider what is already on the table. Over a four-year period--1984 through 1987--spending reductions in the pending reconciliation bill, S. 2062, already total $21.2

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billion. Revenue provisions of S. 2062 raise $21.1 billion over the same four-year period, for a total of $42.3 billion in deficit reduction. These measures have already been reported by Senate committees, so a major part of the work has already been done. It would be foolish to let that work go to waste.

- We can better than double that total of $42.3 billion, without resorting to drastic new measures. Some of the options we are considering are Administration recommendations, or modifications thereof, that restrain spending. Some are tax reforms, including a possible $13 billion in tax-shelter reforms proposed by Treasury. We are talking about proposals that by and large have had Administration support.

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- By 1989 the annual Federal interest cost will amount to $250 billion--about $1,100 for every American.

- That $1,100 per person interest cost is equal to 40% of each person's annual expenditure for food.

- Virtually all economists agree that the sustained enormous deficits that we are facing will be economically harmful.

- Many Americans will find home-buying more difficult with higher deficits. Consider a family purchasing a home at today's current interest rate, averaging about 12-1/2%, with a $55,000 mortgage. If the deficits push interest rates up, total interest costs over the 30 year term will be $15,500 more for each one percentage point increase.

- All Americans will directly feel the results of high deficits if they lose jobs as a result of a business slowdown resulting from a crowding out of private investment, or if they lose jobs to imported products made more competitive because of an abnormally strong dollar or if they end up paying higher prices because inflation is rekindled.

<u>What do you think the Adminstration will propose in its FY 1985 budget to deal the with deficits?</u>

- Clearly the Administration will repropose many of the domestic spending cuts from its 1984 budget that have not been acted upon.

- Based on the figures I have seen, the Administration may propose only about $6 billion in net domestic cuts for FY 1985, but that figure is larger in the out years:

FY 1985	FY 1986	FY 1987	FY 1988
$5.6 billion	$13.7 billion	$17.0 billion	$22.1 billion

- On the tax side, the Administration will likely propose some tax reforms that will raise revenue, including cutbacks in tax shelters Treasury has endorsed.

- While none of these proposals involve huge numbers given the size of our deficits, when they are combined with pending reconciliation measures and additional items, they can provide a substantial 'down payment' on the deficit.

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What about defense spending?

- It is expected the Administration will reccommend $305 billion in defense spending for FY 1985--a 13% real increase over the 1984 defense spending level.

- This sharp increase in defense spending is $16 billion over the substantial increase provided for FY 1985 in the most recent Congressional budget resolution.

- Over the period FY 1985-1987, the Administration's defense recommendation is about $65 billion higher than the 5% real growth path that Congress last year set as adequate for a strong defense.

- The Adminstration's defense recommendation is a first offer that sets its opening bargaining position. I believe that the final defense number for FY 1985 will be close to the $289 billion figure contained in last year's budget resolution.

- Even at a $289 billion level, defense spending will have increased 91% since 1981, the first year of the Reagan Presidency.

WHY SHOULD WE ACT THIS YEAR ON THE DEFICIT

- If we fail to deal with the deficit now, the problem will become worse. Current projections showing deficits holding in the range of $200 billion probably are optimistic, as they are based upon assumption of steady economic growth through 1989. However, postwar experience suggests that the average recovery lasts only 3 years, making a recession in 1985 or 1986 likely.

- If we postpone action until 1985 and we do suffer another recession, the deficits would then hit the $300-$400 billion range. At that point, it may be difficult to cut the deficit without further weakening the economy. Our choices would become very difficult indeed.

- Of course, failure to reduce the deficit in 1984 makes a recession likely to come sooner, as interest rates are forced up by private credit demands clashing with Treasury borrowing needs.

- By postponing action of the deficit, we increase the risk of recession. The average increase in the unemployment rate during a postwar recession is about three points, or three million jobs. By acting to reduce the deficit, we can significantly lower the risk that three million workers will lose their jobs in 1985 and 1986.

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- The rise in interest rates will depress auto sales, housing starts, and capital goods orders. It is widely recognized that sustained economic recovery will be impossible unless these key sectors are healthy.

- Alternatively, the Fed could offset the deficits' impact on interest rates by "monetizing" the debt, leading to a resurgence of inflation in 1985. If we do nothing, we will force the Fed to choose between high interest rates and recession, or inflation.

- Failure to reduce the deficits in 1984 may also depress the stock market. A key factor in determining equity and bond prices is investors' confidence that Congress and the Administration can produce a sound fiscal policy. If we send the signal that the deficit problem is secondary to politics, equity and bond prices may fall.

- The exploding cost of servicing the Federal debt will make controlling spending more difficult each year, unless the deficits are reduced soon. Each year that we add $200 billion in new Federal debt adds about $15 billion to the next year's interest costs.

- The economy is now on a path where more and more of its resources go just to pay off the debt. According to economist Lawrence Summers, "It's a case where the miracle of compounding (interest) works against you."

- In 1976 net interest accounted for just 7% of total outlays But if we do nothing, by 1988 the total Federal debt will be more than half of total GNP, and the net interest cost of servicing this debt will reach 14% of all spending. Each year that we do nothing, the share of Federal spending that we can control gets smaller.

- Recent studies indicate that current and prospective budget deficits may have helped to overvalue the American dollar. If the deficits are not reduced, the problem of overvaluation could become worse, weakening the competitive position of American exports and costing the U.S. jobs in such industries as steel, electronics, and agriculture.

RECOVERY--WHAT PROGRESS HAVE WE MADE

Strength of recovery

- A strong recovery is on track and appears to be moderating to a pace that can be sustained in the years ahead. As an indication, look at the expansion of real gross national product. It grew by

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9.7% in the second quarter of 1983, 7.9% in the third quarter, and an estimated 4.5% in the fourth quarter. By this measure, the recovery is the strongest since 1961.

- Housing starts are running at a rate of about 1.7 million units a year, and new home sales are up by 91% over the recession low.

- Industrial output in 1983 rose 6.5%, and factory utilization is up to 79.4%--the highest level in two years, and close to the normal capacity of 82%.

- The Commerce Department's survey of business plans for 1984 show that business plans to increase capital investment by 9.4%--this is a rate about 2% higher than that seen at comparable points in previous postwar recoveries.

Inflation

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

Creating Jobs

- People are going back to work, and the pace of job creation has been unusually high for a postwar recovery. On January 6 the Labor Department announced the civilian unemployment rate dropped from 8.4% to 8.2% in December. Overall, this means unemployment has dropped 2.5 percentage points over the past year.

- The continued strength of the recovery shows that recent growth in employment has not just been a statistical fluke, but shows a real turnaround in the labor market. Unemployment fell 230,000 in December, and there have been 4 million jobs created in the last year.

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

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