BOB DOLE
KANSAS

United States Senate

OFFICE OF THE MAJORITY LEADER
WASHINGTON, DC 20510

April 26, 1985

MEMORANDUM FOR SENATOR DOLE

FROM: GEORGE PIELER

SUBJECT: TALK TO ASSOCIATION OF RESERVE CITY BANKERS, SUNDAY, APRIL 28, 1985 - 6:30 p.m. BOCA RATON HOTEL

The Reserve City Bankers suggested four broad areas you might want to address in your talk:

1. Your leadership role in the Senate, including how you work with the Democrats and the Administration;

2. Major economic issues: budget, tax, trade;

3. Possible financial institutions legislation in the 99th Congress;

4. How the banking industry can best work with Congress and get its views across.

Attached, in addition to current materials on the budget plan, tax reform and trade are talking points on the deficit and the banking industry.

Attachment

Key Points on Budget Compromise

• Through spending cuts alone, the plan would reduce the deficit by $52 billion in FY 1986, $99 billion in FY 1987, and $146 billion in FY 1988.

• Cuts of this magnitude--totaling $296 billion over 3 years--would leave remaining deficits of $175 billion in FY 1986, $146 billion in FY 1987, and $98 billion in FY 1988.

• This plan reaches the goal we set of getting the deficit down to 2% of GNP by 1988, without tax increases.

• Every area of the budget is hit hard: the President's defense request is cut in half, 17 programs are terminated and still others are phased out, and permanent entitlement savings are achieved by modifying the calculation of all non-means tested COLAs (a 2% guarantee with a CPI-2 formula if inflation is higher than 4%).

• These are real, meaningful cuts and should have a significant impact on financial markets. Preliminary results from a survey of leading Wall Street financial advisers indicates that we should expect interest rates to drop by 1 or 2 percentage points in the near term and by as much as 3 points in 1988.

• If that happens and keeps the recovery on track, we can expect:

- almost 7 million new jobs by 1988
- housing starts back up to the 2 million units/year level
- inflation staying down at 4% or less
- national personal income up by $800 billion by 1988
- potential increase of 18-26% in net income for small business (due to lower interest rates)
- a potential increase of $2-4 billion in net farm income (due to lower interest rates)

Spending Abuses Corrected by the Budget Compromise

• Student aid: We now spend about 1/3 more for high income students at an expensive school than for a lower-income student at an inexpensive school. Reforms in this package would ensure that more aid goes to students from families with the least discretionary income.

• Conrail would be sold as under Secretary Dole's plan--it has been profitable since 1983, meaning that continued government involvement is unjustified.

• The Economic Development Administration would be ended, since it just subsidizes competition for investment and jobs that would occur anyway--55% of its direct loans are delinquent, and it's added $9.4 billion to the deficit over the past 8 years with little national benefit to show.

• The SBA would be abolished: it helps only 1% of small businesses, and 60% of its credit resources go to types of firms that don't need special aid--bars, restaurants, liquor stores (16%), doctors, lawyers, other professional (8%), car dealers (8%), etc.

• Amtrak subsidies would be terminated, savings projected costs of another $8 billion over the next decade. Amtrak was supposed to be a 2-year trial, but has cost $9 billion since 1971. Two-thirds of Amtrak stations board less than 25 passengers a day. 41% of Amtrak riders in the Northeast Corridor have incomes over $40,000.

• Export-Import Bank direct loans would be ended: they now total $3.9 billion a year. Instead we would have a $100 million interest-rate buy-down program to promote exports in conjunction with insurance and guarantee programs. Ex-Im has only financed a small share of exports--1.5% in 1983 and 1984. And Ex-Im loans have not changed the U.S. share of merchandise exports. From 1980 to 1984 nearly half of Ex-Im direct loan financing went to just 5 major corporations (Boeing, McDonnel Douglas, General Electric, Westinghouse, Lockheed).

• The Job Corps would be terminated under this budget plan because it has proven not to be cost-effective. In FY 1985, each Job Corps slot will cost taxpayers over $15,000. That cost exceeds the cost of sending a student to Harvard or Stanford, and more than 3 times the cost of education at the typical 4-year public university. Cost per placement is about 4 times that under the Job Training Partnership Act--and nearly half of the people who leave Job Corps drop out or resign anyway. Only one-third of them are reported employed 6 months after they leave Job Corps.

NON-BANK BANK ISSUE.

- Interstate banking probibtion still remains for banks - that is, institutions which both accept deposits and make loans. Several years ago, banks began expanding across state lines by creating institutions which did not both make loans and accept deposits.

- There is much pressure on Congress to close the non-bank bank loophole and to stop the inroads into interstate banking. Last year, the Senate wanted to give banks expanded powers and to redefine a bank so as to close the loophole. St. Germain would agree to nothing more than a simple bill closing the non-bank bank loophole. Thus, progress was impossible.

- St. Germain reportedly still feels strongly about only enacting a simple bill closing the non-bank bank loophole. At this point, I don't know yet exactly what Jake Garn's plans are.

- Some people feel that recent problems with ag banks, and with Ohio S&L crisis, will make it a tough political climate in which to have Congress restructure banking industry.

REGIONAL COMPACTS

- One way to make inroads on the interestate banking issue is to move gradually - that is, to allow banking across state lines only between neighboring states, if the states agree to the arrangement. THis has been tried in New England. An important test case on the regional compact question has just been heard by the Supreme Court.

- Last week, Paul Volcker made a strong statement on the need to continue to move towards interstate banking. He advocated Congressional action on a regional compact bill - before the Supreme COurt case is decided.

  Many in Congress would like to wait and see what the Supreme Court says first, as legislation may not be necessary.

- Volcker is driven by the desire to avoid making banking policy de facto. He wants Congress to regain control of the process - and to stop the process of making end runs around current laws. I'm not sure that will ever stop no matter what kind of laws Congress passes.

TRADE

Japanese Trade Confrontation

- o Senate passage (92-0) of Danforth resolution calling for Administration restrictions on Japanese imports if trade deficit continues to grow is showing results. Prime Minister Nakesone has made strong personal efforts to make his people aware of the need to import as well as export. Liberalized access is being negotiated for pharmaceuticals and medical supplies as well as for telecommunications equipment. Other sectors under review are forest products and electronics.

- o Proof will be in the effect of these initiatives on the trade deficit. The 1984 level was $36.8 billion out of the total U.S. merchandise trade deficit of $123.5 billion. Raising the quota for automobile exports from 1.85 million units to 2.3 million (450,000 increase) will need to be offset to prevent the deficit from growing in 1985/86.

- o If progress and commitment are evident at the Bonn economic summit (May 2-4), Senate action on the Danforth bill to require Administration restrictions may be unnecessary at this time. Nakesone has indicated that further tariff reductions will be announced by the end of June.

- o The U.S. should continue to concentrate its efforts on putting its own economic house in order through deficit reduction and not exaggerate the impact of foreign imports or look for scapegoats. The trade gap and the sharp rise in foreign investment in the U.S. are important, but they will be best addressed by getting interest rates and the value of the dollar down.

GATT Trade Negotiations

- o The Administration is continuing its effort to pin down support from major trading partners. The EEC has agreed, providing the agenda is defined in advance -- meaning they do not want to commit to negotiating the use of export subsidies on primary products, including agriculture. The decision to begin a new round in early 1986, with preliminary talks to start this summer, is expected at the Bonn summit.

- o Agriculture groups are suspicious that the negotiations will be used only to delay action in responding to foreign subsidies on farm exports. If agriculture is to be included in the talks, the U.S. should be willing to use the same tactics in the interim.

Why the Deficit Matters

- Sustained deficits in the $200 billion+ range are a direct threat of the economy, because they will lead to either higher inflation or stagnation with rising unemployment. Cutting the deficit is the key to creating lasting jobs and restoring our position in international trade.

- The worst risk is that endless deficits will compound themselves: each year that we add $200 billion in new Federal debt adds about $15 billion to the next year's interest costs. The exploding cost of servicing the debt makes controlling spending that much more difficult.

- Endless deficits means higher interest rates--make it more difficult for people to own a home, borrow for their children's education, and plan for the future.

White House-Senate Budget Plan

- This is a very tough, very serious budget--no one underestimates the difficulty of getting it passed. But it also is a balanced, reasonable package that calls on everyone--and every sector with a stake in the Federal budget--to give a little, to do with less Federal largesse than they would otherwise get.

- To demonstrate how serious this budget is: 17 programs would be eliminated. Defense would be held to a 3% increase in each of the next three years: half what the President wanted. And permanent savings would be achieved in all inflation-adjusted, non-means tested entitlement programs by guaranteeing a minimum 2% COLA for the next three years but using a CPI-2 formula if inflation is over 4%.

- In addition, to help lower-income Americans, SSI recipients would get both a full COLA and a $10 per individual/$15 per couple increase.

- All Federal pay, civilian and military, would be frozen for one year.

- The plan meets our goal of reducing the deficit to 2% of GNP by 1988, with reductions totalling about $296 billion over three years.

- This program goes beyond a freeze simply because a freeze is not enough to do the job. A freeze would not address the problem of long-term growth in spending and deficits, which is the key to eliminating fears about the stability of our recovery. In addition, a freeze just postpones making the policy decisions--in terms of priorities among spending program--that have to be made if we are serious about the deficit problem.

o Over the past three years deficits have totalled $606 billion: an average of 5.7% of GNP. That is just not sustainable if we want to continue a strong economic recovery.

o If we do nothing, the situation gets much worse, even under optimistic projections: $716 in additional deficits over the next three years.

o Under the compromise Deficit Reduction Plan, Federal borrowing as a percent of private savings would decline from an estimated 78% this year to 30% by 1988. That will dramatically reduce pressure on credit markets due to Treasury borrowing--free available capital for private investment and job creation--reduce interest rates, and help our trade position.

o Even with this budget plan, we will still be spending an enormous amount to meet the basic needs of our citizens. Nondefense spending still will increase each year, from $520 billion in 1984 to $583 billion in 1988. Similarly, combined Medicare and Social Security spending will continue to rise--from $232 billion in 1984 to $293 billion in 1988: nearly 7 times the amount that was spent on those programs in 1970.

o Means-tested safety net programs are kept intact and will continue to grow as scheduled under present law. The only significant changes are holding Medicaid growth to about 6% a year on a State-by-State basis, and eliminating the 12 cent cash lunch subsidy for families above $20,000. By 1988, safety net spending will still exceed the 1980 level by 72%.

o Agricultural programs will undergo major reforms, but by 1988 we will still be spending over $10 billion a year--much higher than any year before 1980. And don't forget that over the past three years we spent a record $53 billion on farm programs, while largely doing the agricultural economy more harm than good.

Taxes

- The President and the American people have sworn off tax increases as a deficit solution, and no one in Congress seems to want to suggest otherwise. So as far as taxes are concerned, the focus will be on tax reform and ways to improve the distribution of the tax burden.

- There have been a lot of reports and analyses of inequities in the tax code, including one by Joe Pechman on who pays taxes, and one by Ralph Nader's Public Citizen group on corporate loopholes. Despite all the headlines, the bottom line conclusion is one we have known for a long time--payroll taxes and bracket creep raised the tax burden on working people, while the proliferation of tax loopholes cut taxes for the upper incomes and corporations. There, in nutshell, is the source of most of the momentum for tax reform.

- Working people have legitimate concerns in the tax debate: protection of the tax free status of fringe benefits that workers have bargained for, including health insurance--greater equity for the average taxpayer through lower rates and larger personal exemptions. Businesses and workers who don't benefit from rich fringe benefits have legitimate concerns, too, which is why we expect a long and lively debate.

- Clearly tax reform is important, because we must have a tax system that our people believe in and will support without coercion. But unless we deal with the deficit, initiatives such as tax reform will fall by the wayside--because our fiscal crisis will demand all our energy if it gets worse.

- Republicans led the effort to reduce and index tax rates, close corporate loopholes, shut off some upper-income benefits, and improve tax compliance over the past four years. Taken together these changes are the best improvements in tax policy for working people in many years. And without them, scheduled increases in the payroll tax would be pinching workers much more severely than they are. And President Reagan's Treasury Department wants to go further--their reform plan would reduce individual rates, while increasing business taxes by 37 percent.

- The latest report by the Joint Committee on Taxation shows that tax loopholes and preferences will amount to about $424 billion in 1986. Tax loopholes are on a rapid growth path--which is why people are troubled by the unfairness of a "swiss cheese" tax base.

TAX REFORM AND THE BANKING INDUSTRY

- Like most industries that pay a relatively low effective rate of tax, the banking industry stands to lose significant tax advantages if a major tax reform bill goes through.

- For example, the Treasury plan would eliminate the bad debt deduction and the deduction for interest on debt incurred to carry tax exempt bonds.

- According to the Joint Tax Committee, in 1983 the U.S. effective tax rate for financial institutions was only 6.4 percent. For 1980 through 1983 the effective rate was only 3.8 percent. This compares with the average U.S. corporate effective rate of 16.7 percent in 1983.

DEFICIT AND THE FINANCIAL SERVICES INDUSTRY

- The financial services industry, like most industries, will benefit from continued recovery and steadily growing demand for both consumer and commercial credit. Certain segments of the industry also have particular problems stemming from the process of disinflation, from the aftermath of the record high Carter interest rates and inflation, and, from the subsequent recession and recovery.

- For example, banks that expanded lending in the energy and agriculture sectors on the assumption of continued high inflation and the slowdown in both energy and agriculture.

- Reducing the deficit will help the financial services industry in several ways. Regaining economic stability will take a lot of risk out of lending, and lower deficits will mean greater stability by reducing the threat of higher inflation, renewed recession, or skyrocketing interest rates. And lower deficits reduce Federal borrowing, which takes pressure off credit markets and allow more leeway for productive private lending by financial institutions.

- Lower interest rates from lower deficits also mean an expansion in mortgage lending from increased home sales. The National Association of Realtors estimate that a percentage point drops in interest rates would mean 300,000 moreexisting home sales.