BOB DOLE
KANSAS

Kay

United States Senate
OFFICE OF THE MAJORITY LEADER
WASHINGTON, DC 20510

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TO: Senator Dole

FROM: George Pieler

SUBJECT: Talk to Money Market Services group

The group is mainly interested in your view of the U.S. fiscal situation, but of course that also brings into play issues of the value of the dollar and the U.S.' ability to attract foreign investment.

Attached are current materials on the deficit and taxes, as well as current points on trade and new material on the 'Group of 5' agreement on the dollar.

Also, Len has a page on the new trade initiative.

Attachments

THE DEFICIT AND THE AVERAGE AMERICAN

- Unless we enact a massive deficit reduction measure, American families will face either higher interest rates or higher inflation: not to mention the risk of a disastrous new recession throwing millions of breadwinners out of work.

- Most economists believe that enactment of the deficit reduction package as large as the Senate offer will produce a drop of at least 1 percent in interest rates over the short run and 2 to 3 pecentage points over the long term: relative to what they otherwise would be.

- With a 2% drop in interest rates, the monthly payment on a median priced home ($80,000) will go down by about $100 a month.

- Conversely, if we don't reduce the deficit to keep rates as low as they are now, homeowners could face that large an increase-or-more in monthly payments.

- A 2% drop in interest rates would mean an additional $4,000 in income for the average wheat farmer with a 1,000 acre operation.

- This year alone, the Federal government will overspend close to $1,000 for every man, woman and child in America.

- This $1,000 per head of additional Federal debt will be one more burden for our children to repay in higher taxes or higher inflation in the future.

- I don't believe we can let this budget negotiation fail. If we don't act now on major deficit reduction, the American people will pay the price. By 1989, interest on the debt alone would take up half of all individual income tax payments. The interest cost would be $250 billion or $1,100 for each American.

- If we can get something like this package I am very, very optimistic about the course of the economy. I think we take too much for granted what we have achieved so far: strong growth without inflation. We can keep that going if we reduce the deficit substantially. The way is open to economic performance unprecedented in the postwar period if we have the will to find it.

ESCALATING DEFICIT

The main threat to continued economic expansion is run-away Federal spending.

- Since 1940, the Federal Government has run deficits in 37 out of the last 45 years. Since 1960, we've run deficits in 24 out of 25 years.

- In 1985, the gross Federal debt will total $1,841 trillion, an increase of 533% over 1960, 238% over 1975, and 101% over 1980. The total debt in 1985 now stands at 48% of our GNP.

- With no changes in Federal spending policy, CBO projects that Federal outlays will rise from $950 billion in 1985 to $1,378 trillion in 1990--an increase of $428 billion in five years.

- If no changes are made, the budget deficit will increase from $214 billion in FY 85 to $300 billion in 1990 and the National debt will increase to $2,786.

INTEREST ON THE DEBT

This massive increase in debt has itself created one of the largest and fastest growing components of Federal spending--interest on the debt. Constant deficits have put fiscal policy on an endless treadmill of paying for the irresponsibility of previous decades:

- In 1965, interest on the National debt cost $9 billion and consumed 1.4% of GNP. By 1980, annual interest costs rose to $52 billion--2% of GNP. But the worst was yet to come.

- In 1985, interest on the National debt will cost taxpayers $130 billion--almost three times the level of five years ago. This represents 3.8% of GNP, 13.5% of the entire 1985 budget, and a 1,450% increase in costs over 1965.

- $130 billion is equal to the sum total of all Federal spending from 1789--the founding of the Republic--to 1936. It also equals total Federal outlays in 1966, the entire defense budget in 1980, and twice the level of medicare funding today.

- To put it in even simpler terms, about 40% of all revenue collected by the Federal Government from personal income taxes ($330 billion in 1985) will go to pay interest costs and no Federal services at all.

Reagan Initiative on the Dollar

• The new Reagan administration initiative to moderate the value of the dollar involves commitments by the U.S., Japan, West Germany, France, and Great Britain. The agreement among these five nations was worked out by the finance ministers and central bankers of the five: Paul Volcker and James Baker representing the U.S.

• The major new factor in the agreement is the U.S. commitment, at least in principle, to coordinated intervention in foreign exchange markets to moderate the value of the dollar. That commitment can have a major psychological impact that could ease the dollar down (obviously no one wants the dollar to crash). In addition, this commitment by the U.S. explicitly acknowledges the role the high dollar is playing in undermining the U.S. trade position.

• In addition, Japan and the European parties to the agreement commit to boost growth in their countries, thereby increasing their domestic demand (including demand for U.S. products and services), and hopefully strengthening their currencies.

• Finally, the U.S. commits to reduce our budget deficits further and resist 'protectionism'. These steps clearly are aimed at reducing the U.S. need to import capital (which requires a dollar that attracts investment) while keeping the engines of world growth going.

• These are all positive developments, and the agreement is a major step forward just in acknowledging, by common consent, the nature of the economic problems we share with the other major developed nations. But we have to realize that there is only so much that can be achieved by 'jawboning' about the high dollar, and by exchange market intervention to control 'blips' in the dollar's value. The real meat of this agreement is in its focus on economic fundamentals--that is where it will be most difficult to follow through, and where it is critically important that we do so.

• We, the U.S., have to dramatically reduce our budget deficits. That means resuming, as soon as possible, the budget battle that we seem to have put aside for now. It also means pursuing every avenue the President outlined in his trade address, in order to fight unfair trade barriers without falling into the protectionist trap. And it means we must continue to coordinate closely with our friends abroad to see that they make progress towards <u>their</u> economic goals of speeding up their rates of economic growth and pursuing stable monetary and fiscal policies.

TRADE

o Historically, free trade has spurred U.S. economic growth, and fair competition from abroad has encouraged our industries to be more efficient. As a Senator from an agricultural state, I appreciate the importance of world markets for U.S. farmers. But, the United States cannot be the world's only free trader any more than we can unilaterally disarm.

$150 BILLION TRADE DEFICIT

o Last year, as you know we faced a record shattering $123 billion merchandise trade deficit and this year it could reach $150 billion. Our deficit with just four of the places I recently visited--Japan, Korea, Taiwan and Hong Kong--will amount to $70 billion this year.

o This gross imbalance has devastated important sectors of our economy, particularly manufacturing which is costing us millions of jobs, offsetting employment gains in the service sector. In the last ten years, it is estimated that the United States has lost over 600,000 jobs in just three industries alone: textiles and apparel, steel and footwear. And this trend has now spread to such high technology areas as telecommunications and semiconductors.

IMPACT ON AGRICULTURE

o The deterioration in the U.S. trade position has been equally pronounced in the agricultural sector. From a record high of $43.5 billion in 1980, farm exports have plummeted $10 billion in the past five years.

o To a large extent, our trade woes are self-inflicted. American business can be faulted for not being more aggressive in pursuing export markets. The U.S. economy also has recovered from the worldwide recession more quickly and vigorously than the economies of our major trading partners. The biggest culprit however is the overvalued dollar, which has made U.S. goods 40% more expensive over the past four years -- and at the root of this problem is our inability to control budget deficits.

o The best known of the trade bills include the Thurmond/Jenkins bill, which estabishes annual limits on the growth of all imports of textiles and apparel, except for goods from the EC and Canada. With 53 cosponsors in the Senate and over 290 in the House, passage must be considered a strong possibility. Another major contender is the Danforth/Finance Committee bill responding to Japanese Unfair Trade Practices, which mandates U.S. retaliation unless Tokyo acts to remove trade barriers. A similar nonbinding resolution passed the Senate by a vote of 92-0 in the spring. There is also the Bentsen/Rostenkowski bill, which provides for a 25% surcharge on all imports from Japan, Taiwan, Korea, and Brazil.

OPTIONS

o Section 301 authority permits the Administration to respond by imposing tariffs, import quotas, or other restrictions, when an unfair foreign trade practice is burdening U.S. commerce. But Section 301 has only been used in two cases since its enactment in 1974. There are indications the Administration has recognized this need.

Some of the options available to Congress would include:

- More active and coordinated exchange rate policy.
- A temporary and generalized increase in U.S. tariffs to offset the effects of the overvalued U.S. dollar and reduce the U.S. budget deficit.
- A review of the Generalized System of Preferences (GSP) to eliminate some of the better-off beneficiary countries.
- Reform of U.S. trade remedy laws to make them more responsive to complaints by U.S. industry and encourage more expeditious adjusment to foreign competitors.

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.

- 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.

Reagan's Tax Reform

- The President has proposed a striking and historic revision of the income tax laws. His plan would make the system both simpler and fairer.

- The present 14 brackets would be replaced by just three: 15%, 25%, and 35%. The maximum corporate rate would drop to 33% (with graduated rates for small business).

- The plan as a whole would shift the tax burden away from working people and toward businesses that have a lot of income but haven't paid their share of tax. Total taxes paid by individuals would drop 7 percent, while corporate tax payments would rise about 9 percent.

- Distributional Offset. Under the Reagan plan, families with incomes of $10,000 or less would get a 35.5% tax cut; $10,000 to $15,000, a 22.8% tax cut; $15,000 to $20,000, a 13.5% tax cut; $20,000 to $30,000, an 8.7% tax cut; $30,000 to $50,000, a 6.6% tax cut; $50,000 to $100,000, a 4.2% tax cut; $100,000 to $200,000, a 4.1% tax cut; and $200,000 or more, a 10.7% tax cut (the larger-than-average break for the top income group results from the lower top rate of 35% and the lower top capital gain tax rate of 17.5%).

- Return Free System. Under the Reagan plan, only 33% of taxpayers are expected to itemize. In addition, more than half of all taxpayers would be able to get their tax bill or refund without filing a return (if they so choose).

- Protection for Low Income. The plan would remove from the tax rolls virtually all families, married couples, single heads of households, and older Americans at or below the poverty line. This would result from the combination of increasing the personal exemption, zero bracket, earned income credit, and the new consolidated credit for the blind, elderly, and disabled.

- Indexing Protection. The plan retains the indexing protection for rate brackets, the personal exemption, and the zero bracket which we pioneered in 1981. Most plans that claim to do more for middle incomes (like Bradley-Gephardt) do not protect taxpayers against inflation and would do less for them in the long run. President Reagan also expands the indexing concept to the earned income credit, protecting the working poor, to depreciation and to capital gains (in 1991).

- Business and Growth. President Reagan proposes a system of business taxation that is more neutral and will reduce tax-motivated distortions that skew economic decisions. Repealing the ITC and revising depreciation schedules mean greater neutrality among different investment categories. Other changes that will limit economic distortions include limiting real estate tax breaks to the amount at risk, and tightening the minimum tax with regard to oil and gas tax breaks (intangible drilling costs).

- Issues to Watch. Congress is giving the President's plan a very close look, and no doubt many Members have particular changes they want to propose. In particular, there will be focus on:

  - Distribution of Tax Burden. Some are concerned about the break for the top income class--but to address that would require changing the rate structure on the capital gains exclusion, both very sensitive issues. Secretary Baker's proposals to drop inventory indexing, eliminate 401(k)s, and restore the child care credit will help make the case this is a revenue-neutral plan.

  - Neutrality/Investment. Any perceived deviation from "neutral" tax treatment for different industries will bring demands for change from other industries. In addition, those industries most heavily subsidized by the current code--like those which benefit from the ITC because they are capital-intensive--will want to minimize the effect of the plan.

  - State and Local Taxes. Secretary Baker has said that eliminating the deduction for State and local taxes is a sort of "acid test" for serious tax reform. This is a $40 billion item over the projected phase-in period, and that amount would be difficult to make up. If high-tax States can fight off this change--even in the context of much lower tax rates and other benefits that ease the tax take on their citizens--progress may be difficult. A compromise that doesn't lose much revenue may be necessary.