BOB DOLE
KANSAS

United States Senate

OFFICE OF THE MAJORITY LEADER
WASHINGTON, DC 20510

December 4, 1985

TO: Senator Dole

FROM: George Pieler

SUBJECT: Talk to Merrill Lynch Private Capital group

For your talk to the Merrill Lynch group Thursday morning at 8:00, attached are talking points on tax, budget, trade, and the dollar.

The same group will be hearing from Bill Diefenderfer later tomorrow morning, and from Senators Danforth, Bradley, Rudman and Lugar on Friday. The might like an overview from you on what will be happening in the Senate in the next few months, particularly as it affects the economy.

Attachments

Senate agenda

o For the remainder of the year, budget and deficit-control measures will dominate the Senate schedule: plus housekeeping matters that simply have to be done this year. We need to reach a conference agreement on budget reconciliation, to carry appropriations through next year, and to work out a version of the Gramm-Rudman deficit control measure: plus pass a long-term debt limit increase.

o The balanced budget amendment is still high on the agenda, but given time constraints may have to wait until early next year. But the longer we drag on with frustrated attempts to deal with the deficit through the budget process or on the debt limit, the clearer it becomes that an overriding constitutional limitation is needed. With 32 States petitioning for such an amendment, we in Congress have the responsibility to take the initiative.

o In addition, we need to have a farm bill conferenced and signed into law; we may have to deal with expiring tax code provisions; and prepare for major debates next year on comprehensive trade legislation and on tax reform.

GRAMM-RUDMAN

How The Senate Bill Works

- For each fiscal year from 1987-1991, the President must submit a budget that meets the deficits mandated in the Gramm-Rudman-Hollings plan.

- Starting this year, if estimates by the CBO and OMB project a deficit that exceeds the deficit target contained in the legislation -- the President must issue a "sequestering" order. The President has 14 days after receipt of the report to issue the order if there is positive GNP growth, 30 days if negative real growth is projected. (The same procedure will follow each year.) For fiscal 1986, the maximum deficit is $180 billion; fiscal 1987, $144 billion; fiscal 1988, $108 billion; fiscal 1989, $72 billion; fiscal 1990, $36 billion and fiscal 1991, $0 billion.).

- The President must eliminate the excess expenditures by reducing automatic spending increases (e.g. entitlement COLAs) across-the-board, and by reducing other (controllable) spending. Each category would have to contribute one-half to the reduction plan. The actual sequestering, if it were to take place, would take effect 30 days after the Presidential order was issued. However, within 10 days of the Presidential report, the Congressional budget committees could propose an alternative plan for achieving the same deficit reduction.

- The President could suspend the deficit limitation of Gramm-Rudman-Hollings in the case of a recession.

- Social Security is not eligible for reduction.

Major Conference Issues

- Whether the sequester order, if it occurs, should fall equally (50/50) on defense and domestic spending.

- Whether certain low income programs (AFDC, Food Stamps, SSI, child nutrition) will be exempt from the sequester order.

- What the deficit targets will be each year.

Talking Points

- The proposal establishes the kind of guaranteed downward glide path on deficits that virtually all Senate Republicans set as our goal last January.

- The Gramm-Rudman-Hollings proposal does not tie our hands except to force us to meet our targets. We are given the opportunity, as is the President, to propose alternative means of meeting our targets if we choose not to sequester funds across the board.

- Obviously the broader the spectrum of programs dealt with by the proposal, the fairer it is preceived to be. However, having spent a considerable period of time on the subject of social security in our earlier debate on the budget it was clear that this one issue could again derail our efforts to achieve serious long-term deficit reform.

Weaknesses and Negatives

- Obvious weakness is that what Congress writes into law, it can rewrite and undo.

- Congress has regularly missed the deadlines under the existing Budget Act.

- The cuts in the defense budget may be far greater than the Administration is willing to accept. If the Administration does not live up to the letter of the law on defense then it will be harder to make cuts in other domestic programs stick.

- Not realistic that Congress could come up with an alternative in 10 days. It took 10 days to get the Gramm-Rudman-Hollings proposal off the floor.

- There is the problem with projections -- what if a recession happens in the middle of the year -- one that OMB or CBO does not project. Benefits are going to be taken away from people when they most need them.

- With Social Security off the table, a huge chunk of Federal expenditures are off limits. But we lost that battle earlier in the year.

- There is a particular problem with agencies that have lots of loan guarantees like Agriculture where the fiscal year and loan timings do not coincide.

o Finally, no legislation can mandate backbone. And ultimately, Congress will have to make policy decisions that are not going to be easy -- either politically or substantively.

Despite these weaknesses, however, the Gramm-Rudman-Hollings plan is an important step in tightening up the budget process -- both for the Administration and Congress. And under the emergency situation we now find ourselves -- where resolving the deficit crisis will determine whether the U.S. economy continues to grow, this action is more than warranted.

We are not in this mess because of Republican policies. The 1981 tax cut helped spark one of the strongest and longest economic rebounds since the end of World War II. Inflation and unemployment remain at low levels, while interest rates have tumbled.

BALANCED BUDGET AMENDMENT

- The balanced budget amendment is an appropriate long-term response to our fiscal problem: our inability to eliminate deficit spending. Even with strong public pressure to balance the budget, Congress hasn't been able to do so. We need an institutional restraint--in the Constitution--to help us keep the public interest ahead of special interest pressures.

- Legislation to require balanced budgets has never succeeded, because it can simply be overridden by a subsequent action of Congress. The Constitution should not lightly be tampered with, but there is no longer any question that our sorry record on deficits and spending is causing great concern throughout the country, and around the world. That is why 32 of the 34 States required to call a constitutional convention on this issue have petitioned Congress for such a convention--that is a message that we in Congress have to heed, and a 33rd State may join the roster this year. I have been in Michigan three times this year to urge support for a balanced budget amendment.

- The fundamental problem of deficit spending demands a fundamental solution. The balanced budget amendment reported by the Senate Judiciary on July 11 does not embody any particular economic theory, but just requires that Congress be specifically accountable for its decisions on fiscal policy.

- The amendment would just require a 3/5 vote to adopt a deficit budget, and an actual majority (51 Senators, 218 Representatives) to raise the level of taxation as a percent of the national income. That is all there is to it: increased accountability, and an appropriate counter to the never-ending pressures for responding to special interests.

- This is not a partisan issue and it is certainly not a quick-fix: we have to do everything we can right now to reduce spending and deficits. But we also need to reform the basic way we deal with the budget in Congress. The balanced budget amendment would limit our options in a way that is good for us and good for the country.

- No one claims that a fiscal restraint amendment is a panacea for our immediate deficit dilemma, and it should not be used as an excuse for ignoring our own lack of responsibility in failing to make a real impact on the triple-digit deficits we are facing. For that we need substantive legislation to reduce spending, well beyond what we agreed to do in this year's budget resolution.

ECONOMIC DEVELOPMENT ADMINISTRATION

- FY '86 Appropriations for the EDA are now in conference. committee. The Senate version appropriates $160 million for the program. The House version appropriates $180 million for the program. The qualifying rules for the various grants are the same as previous years.

SMALL BUSINESS ADMINISTRATION

- Small Business Administration FY '86 Appropriations are now in conference. Both the House and Senate versions parallel each other except for minor differences.

- All District offices will remain open, Sec. 503 program is continued, and the guaranteed loan program will be funded around the $2.5 billion level.

- Salaries are frozen for all personnel and the farm disaster loan program is eliminated. All direct loan programs are eliminated except for the handicapped and Vietnam Vets. Senate version adds minorities as well.

Tax Reform Talking Points

- Conceptually, the President's proposal and the Ways and Means Committee bill are quite similar--they both shift more of the tax burden to corporations and reduce the tax burden on individuals.

- Both substantially reduce tax rates for individuals (the President to a maximum of 35%; Ways and Means to 38%) and for corporations (President 33%; Ways and Means 36%). But the Ways and Means rates take effect at much lower income levels: the 35% rate clicks in at $43,000 for married couples, as opposed to $70,000 under the Reagan plan.

- Neither plan gets an A+ for the major objectives of tax reform--simplification and fairness.

- The President's plan repealed many of the complicated provisions of current law and thus did a better job of simplification than the Ways and Means Committee effort, which modified, but left in place, many of the complex incentives.

- If fairness means having taxpayers with equal incomes pay similar amounts of tax, the Ways and Means Committee did worse than the President. Fringe benefits and itemized deductions are the major causes of differing tax liabilities. Unlike the President's proposal, Ways and Means retained the State and local tax deduction, limited interest paid deductions less, and did nothing on fringe benefits.

- The Ways and Means Committee retained many of the politically popular big-ticket items. Unless we want to tackle those, the Senate will have limited flexibility in trying to enhance investment and savings incentives.

- I have personally long favored income tax reform and, as Chairman of the Senate Finance Committee, lead the fight over a number of years to plug unjustified tax loopholes.

- Nevertheless, I know that many of my Senate colleagues have no enthusiasm for the President's version of tax reform and even less for the Ways and Means bill, which they view as even more likely to have harmful economic effects. In the Senate, with its more open procedures, it is easier for a determined minority to block or slow down a bill they oppose.

- It is possible that the Senate might be able to fashion its version of a tax reform bill by June, but only with intensive effort by the President to push the bill and reshape it along the lines he favors.

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).

- <u>Business and Growth.</u> 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).

- <u>Issues to Watch.</u> 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:

  - <u>Distribution of Tax Burden.</u> 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.

  - <u>Neutrality/Investment.</u> 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.

  - <u>State and Local Taxes.</u> 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.

RECONCILIATION BILL

On November 14, by a vote of 93 to 6, the Senate passed the Omnibus Reconciliation Act of 1985. What follows is a summary of the savings that were achieved.

	FY 1986	FY 1987	FY 1988	Total FY 1986-88
SENATE				
Reductions in outlays	-19199	-22147	-28645	-69991
Increase in revenues	2225	6269	7263	15757
Reduction in deficit	-21424	-28416	-35908	-85749
HOUSE				
Reductions in outlays	-18422	-22880	-27206	-68508
Increase in revenues	2809	4392	4857	12058
Reduction in deficit	-21231	-27271	-32063	-80565
DIFFERENCE				
(Senate savings above (+) or below (-) House Savings)				
Reductions in outlays	777	-733	1439	1483
Increase in revenues	-584	1877	2406	3699
Reduction in deficit	193	1145	3845	5184

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 percentage points over the long term: creative 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.

- Under current fiscal policies, if no action is taken to curb deficits, interest on the debt will rise to $230 billion in 1990, about 15% of the budget. This will equal almost half of all personal income tax revenue.

TRADE

- 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

- 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.

- 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

- 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 has plummeted $10 billion in the past five years.

- 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 economics 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.

- The best known of the trade bills include the Thurmond/Jenkins bill, which establishes 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

- 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 sinces 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 adjustment to foreign competitors.

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 their economic goals of speeding up their rates of economic growth and pursuing stable monetary and fiscal policies.

TRADE ENHANCEMENT ACT OF 1985, S. 1860

OVERVIEW

The purpose of the legislation is to:

- Ensure systematic enforcement of existing trade laws against foreign unfair trade practices (Section 301 reform).
- Expand trade through market liberalizations.
- Promote meaningful adjustment of import-impacted industries to new competitive conditions (Section 201 reform).
- Remedy misalignment of the dollar, developing country debt, and disincentives to U.S. exports (includes authorization of $300 million "war chest" to counter foreign export credits).

Of particular help to Kansas:

- Section 301 reforms: This title, which focuses on removing barriers to U.S. exports, would be of particular help to the aircraft industry.

  The Brazilians currently ban the importation of civilian aircraft while exporting these planes to the U.S. and other nations. The bill requires initiation of cases against this type of barrier in addition to establishing mandatory deadlines for retaliation against uncorrected violations.

- The legislation also expands the definition of unfair practices to include "targeting" policies. Actions under 301 will now be in order to the extent that a foreign country provides export subsidies, infant industry protection or diversion of trade into the U.S. market, which individually or in combination, threaten to burden or restrict U.S. commerce.

- New GATT Round Authority: Establishes specific Congressional ojectives for a new round which include the elimination of foreign agricultural export subsidies.

- Export Expansion: Authorizes a $300 million "war chest" sought by the President to counter foreign export credit subsidies, including those for agricultural products, which undercut our ability to compete in the world markets.

TRADE ENHANCEMENT ACT OF 1985, S. 1860
33 Cosponsors
Introduced November 20, 1985

BRIEF OVERVIEW OF MAJOR PROVISIONS IN BILL

1. **Section 301 Reform**

   Requires automatic initiation of Section 301 cases by USTR when another country's unfair trade practices burden, distort or restrict a substantial amount of United States exports.

   When an unfair trade practice is identified, after a period of time for negotiation, the bill requires that retaliation take place. Other changes made to Section 301 include transferring the initiation authority from the President to USTR and a new definition of "burden" for purposes of determining whether an unfair trade practice has taken place.

2. **Section 201 Reform**

   Amends the law to require that import relief be given to industries the ITC finds to have been injured.

   The bill also requires that an injured industry prepare an adjustment plan that would, over time, result in their altering their methods of doing business or producing a product in order to become more competitive.

3. **New Round Authority**

   Provides authority for President to enter a new round of GATT negotiations, and links to this authority a list of specific negotiating objectives.

4. **Dollar/Exchange Rates**

   Requires President to work with G-5 countries to improve functioning of the international monetary system. In addition, creates a strategic exchange reserve to assist in moderating exchange rate fluctuations, and makes funds available to assist LDC debtor nations.

5. Generalized System of Preferences (GSP)

Requires the President to establish criteria for the graduation (within 2 years) from GSP of advanced developing countries, (i.e., Hong Kong, Korea, Taiwan).

6. Non-Market Economy Dumping

Streamlines the procedure for bringing anti-dumping cases against non-market economies.

7. Section 337 Protection (Intellectual Property Rights)

The bill expands protection for process patents and other intellectual property.

8. Export Promotion

The bill includes the President's proposal for the establishment of a war-chest and other steps to promote exports including making technical revisions and clarifications in the Foreign Corrupt Practices Act to help companies operating abroad. We incorporated many of these latter changes as a result of our discussions with the Hong Kong Chamber of Commerce.

The bill does not provide for industry-specific protection such as protection for textiles, shoes, etc., although each of the titles of the bill are likely to contain provisions which are particularly helpful to particular industries.