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WASHINGTON, DC 20510

February 19, 1986

TO: Senator Dole

FROM: George Pieler

SUBJECT: Talk to Hong Kong/U.S. Economic Cooperation Committee

Attached are current materials on the budget, the economy, and tax for your talk to the Hong Kong/U.S. Economic Cooperation Council, Thursday, February 20, at noon at the Capitol Hill Club.

There is also a general interest in trade: not the textile bill, but the atmosphere in Congress and the prospect of any major trade initiatives. Attached is a description of your omnibus trade bill, S. 1860.

Vic French advises that this organization does not lobby, but exists to strengthen economic relationships (i.e. encourage an increase in the volume of trade) between the U.S. and Hong Kong. Vic also stresses that Hong Kong imposes "no trade barriers of any kind on U.S. exports."

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THE ECONOMY IN 1986

- o No one can really predict the course of the economy in 1986, although of course we have to take a stab at it to guide our budget decisions. But it is increasingly clear that the economy began picking up late last year. Leading indicators rose 0.9% in December, the eighth month in a row. Unemployment is down to 6.7%, the lowest since 1979.
- o There are forces at work that improve the prospects for strong growth this year. One of these is the drop in oil prices, which acts like a tax cut for energy users and helps moderate inflationary pressures that might build as a result of the dollar's decline. Coupled with the monetary stimulus the Federal Reserve provided in the last six months of 1986, and the prospect for improvement in our balance of trade later in the year (as the effects of the dollar decline are felt), this means we have a good chance for healthy growth in 1986.
- o Clearly the number one threat to maintaining a healthy economy remains the U.S. budget deficit. If it's not reduced sharply this year, we won't meet the commitment we made to our trading partners to secure their agreement to ease the dollar down. What's more, we would put an unconscionable burden on the Federal Reserve to keep the recovery going by pumping more money out in order to keep interest rates down. That's a sure recipe for inflation.
- o We've created 9 million jobs with a near record economic recovery. We've got inflation down to the lowest levels in two decades. Let's not throw it all a way by punting on the deficit issue. The fact is that all the economic pundits we've been hearing in recent years have been wrong: the economy is more resilient than many believed, but not so strong as to be able to sustain huge deficits this late in the recovery. It's time for everyone to "give" a little in the interest of a deficit-reduction plan that will steer us safely through the potentially treacherous waters ahead.

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BUDGET FOR FY 1987

- o The President's budget for FY 1987 is a blueprint for deficit reduction that Congress will have to take seriously even if we can't agree with it in all particulars. It is important to keep in mind OMB Director Miller's contention that, if we adopt this budget in full, we can meet the Gramm-Rudman targets for the rest of the decade without the need for major additional cuts.
- o The 1987 budget plan is designed to get the deficit down to \$143.6 billion: just below the G-R-H target of \$144 billion. Total spending is projected at \$994 billion, and revenues at \$850.4 billion. Total interest expense is \$206.85 billion, and net interest (exclusive of intra-government payments) is \$148 billion.
- o The deficit would be reduced by \$38 billion in FY 87, and by \$166 billion over three years. Defense would still grow by 3% in real terms (increase in budget authority adjusted for inflation). Increased funds would be provided for fighting terrorism, for law and drug enforcement, for the space program, aviation safety, and AIDS research.
- o Major new deficit-reduction initiatives include privatization of government activities, ranging from Amtrak to power facilities to Ex-Im bank loans; transferring a few programs to the States, such as the Agriculture Cooperative Extension Service and highway; a wide array of user fees on government services; eliminating programs like EDA, UDAG, SBA, maritime subsidies, and the ICC.
- o There are additional receipts in the budget as well: extending the cigarette tax, higher fees for black lung, repealing the gasohol exemption, increased contributions to civil service retirement and the like.
- o The CBO indicates that the President's budget may be some \$14 billion short of its 1987 goal because of low estimates of defense spending already in the pipeline. That is a legitimate matter for review, but if baseline spending is higher, then any cuts will have more of an impact as well.

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Gramm-Rudman, the Dollar, and Inflation

- o Gramm-Rudman should help us meet the commitment we made last September to our trading partners: to reduce the deficit as part of our effort to moderate the value of other dollar.
- o By the same token, the risk of inflation should be reduced if we bring down the deficit under Gramm-Rudman, because the pressure to pump up the money supply to keep interest rates down will ease considerably.

Gramm-Rudman: Challenge to the Established Fiscal Order

- o The first actions in response to the new Gramm-Rudman deficit control reform will be taken early in 1986. For those of you who missed it, late last year the Congress imposed a new fiscal straightjacket on itself. The new law sets firm deficit targets for each of the new five years, and mandates automatic across the board spending cuts if the deficit exceeds the target. The first round of automatic cuts under the proposal will take effect March 1 unless Congress comes up with a better way to meet the target.
- o In addition, President Reagan's budget for fiscal year 1987 is due to Congress by February 5. So we will have reconsideration of the 1986 budget proceeding simultaneously with our first shot at the 1987 budget.

That is a tall order, but is one we ought to be able to fill. Difficult as it seems, we should remember that the Gramm-Rudman law contains new procedures designed to make it easier to meet the deficit targets. We explicitly bring loan programs and other 'off-budget' items into the budget process; set a point of order against legislation from committees that have not met their budget savings allocation; and rule out of order legislation inconsistent with the deficit targets.

Possible Problems. We know there will be a rocky road ahead in implementing Gramm-Rudman. Congressmen Synar and others already have won the first round in their suit claiming it is unconstitutional, and the Reagan Administration also has some problems with the role of the Congress' General Accounting Office in mediating the deficit forecasts. The Supreme Court will have to give us a final ruling on all that in a few months. Even more important, what Congress can legislate, Congress can back out of. That's why we need a constitutional mandate for budgetary restraint, as well as a statutory one.

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- o So Gramm-Rudman hasn't made our options any easier: but if it works as planned, it will force us--and the President--to make some decisions and choose among the various deficit-reduction options. That means everyone's cherished spending programs will be put to the test of fiscal responsibility.

Spending the Key. Finally, let me emphasize that Gramm-Rudman is a device for reducing Federal spending. It is not a tax increase plan, or a subterfuge for one. If we fail on the spending front, we can look at other options. But the sooner we entertain any revenue options, you can bet the pressure for spending cuts will drop fast.

The Deficit and the Average American

- o Unless we follow a deficit reduction path like that mandated under Gramm-Rudman, 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. That is what the Gramm-Rudman-Hollings initiative is all about.
- o Most economists believe that enactment of deficit reduction measures that eliminate the deficit by the end of the decade 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: relative to what they otherwise would be.
 - With a 2% drop in interest rates, the monthly payment on a median priced home (\$80,000) would 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.
 - In 1985, 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.

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Interest on the Debt

The 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:

- o 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.
- o In 1985, interest on the national debt 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.
- o \$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.

But if we can adhere to the deficit-reduction goals we've set for ourselves, 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.

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Tax Reform Talking Points

- o The President's tax plan and the House bill are similar in concept--they both shift more of the tax burden to corporations and reduce the tax burden on individuals. But the bills are very different in how they make the change.
- o 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.
- o Neither plan gets an A+ for the major objectives of tax reform--simplification and fairness, but the President's plan repealed many more of the overly complicated provisions of the tax code than the Ways and Means Committee effort. The House bill just modifies, but leaves in place, many complex tax rules.
- o The House bill falls far short of the President's on fairness grounds. Fringe benefits and itemized deductions are major causes of differing tax liabilities, and unlike the President's proposal, the House retained the State and local tax deduction, did less to limit interest-paid deductions, and did nothing on fringe benefits. This means that taxpayers with equal incomes can still have substantially different tax liabilities.
- o I have personally long favored income tax reform and, as Chairman of the Senate Finance Committee, led the fight over a number of years to plug unjustified tax loopholes.
- o It is possible for the Senate to fashion a tax reform bill by June, but only with an interest intensive effort by the President to push the bill and reshape it along the lines he favors: and to help us along in finding a bipartisan solution to this year's deficit problem.

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.

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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.