

9RS1000
CONFIDENTIAL
DESKBY 270900Z

CONFIDENTIAL

Prime Moments (2)

HT 27/11

FM WASHINGTON 262347Z JANUARY, 1984
TO IMMEDIATE F C O
TELEGRAM NUMBER 306 OF 26 JANUARY
INFO PRIORITY PARIS, UKDEL OECD, BONN, UKREP BRUSSELS, TOKYO
AND ROME.

MY TELS NOS 295 AND 296: STATE OF THE UNION ADDRESS:
PRESIDENT REAGAN AND THE US BUDGET DEFICIT

MS

SUMMARY

1. THE PRESIDENT'S ADDRESS INVITES THE CONCLUSION THAT HE DOES NOT WISH TO MAKE HARD ECONOMIC CHOICES IN AN ELECTION YEAR. THE PUBLIC OPINION POLLS SHOW THAT THE CHIEF REASON FOR HIS PRESENT POPULARITY IS THE PERFORMANCE OF THE ECONOMY, FOR WHICH HE SENSIBLY TOOK CREDIT, AND THAT THE VAST MAJORITY OF AMERICANS DO NOT WISH TO HAVE TO PAY EARLY TAX INCREASES, OR EVEN TO BE PSYCHOLOGICALLY CONDITIONED FOR TAX INCREASES AT A LATER DATE BY THE ANNOUNCEMENT OF SOME FORM OF CONTINGENCY TAX INCREASE SUCH AS THE ONE IN LAST YEAR'S BUDGET. HIS SPECIFIC PROPOSALS HAVE TO BE SEEN AGAINST THAT BACKGROUND.

DETAIL

2. THERE ARE A NUMBER OF PROPOSALS, NONE VERY CONVINCING FOR DEALING WITH THE BUDGET DEFICIT. SOME OF THEM WILL NO DOUBT APPEAR IN THE FY85 BUDGET, WHICH IS TO BE SENT TO THE CONGRESS ON 1 FEBRUARY, BUT OTHERS ARE LONGER-TERM AND PROVIDE A GENERAL INDICATION OF THE DIRECTION OF THE PRESIDENT'S THINKING FOR THE FUTURE BEYOND THE NOVEMBER ELECTIONS.

3. THERE IS AN IMPLICIT ADMISSION IN THE ADDRESS THAT THE PRESENT LEVEL OF THE STRUCTURAL BUDGET DEFICIT IS UNSATISFACTORY, BUT THAT SIGNIFICANT TAX INCREASES WOULD IN THE LONG-RUN MAKE THE STRUCTURAL DEFICIT EVEN WORSE. THE PRESIDENT SAID HE WISHED TO REDUCE THE ROLE OF THE GOVERNMENT IN THE OVERALL ECONOMY, WHICH MEANT REDUCING PUBLIC EXPENDITURE AND NOT INCREASING TAXES. BUT HE DID NOT IDENTIFY THE SPECIFIC AREAS IN WHICH EXPENDITURE CUTS COULD BE ACHIEVED. THE OUTLOOK FOR ACHIEVING PUBLIC EXPENDITURE SAVINGS IS NOT BRIGHT. STOCKMAN HAS PUBLICLY EXPRESSED THE VIEW THAT THEY ARE GOING TO BE VIRTUALLY IMPOSSIBLE. THE FINANCIAL MARKETS MUST DOUBT THE ABILITY AND DETERMINATION OF THE PRESIDENT TO DEAL WITH THE DEFICIT EVEN BEYOND THE NOVEMBER ELECTIONS.

4. ONLY MINOR PUBLIC EXPENDITURE REDUCTIONS ARE LIKELY TO BE PROPOSED FOR THE FY85 BUDGET, POSSIBLY REDUCING THE DEFICIT BY ONLY DOLLARS 5.6 BILLION IN FY85. THE TAX PROPOSALS WILL PROBABLY REDUCE MINOR LOOPHOLES AND MAKE TECHNICAL CORRECTIONS. THE PROPOSAL FOR A CONTINGENCY TAX SEEMS VIRTUALLY CERTAIN NOT TO REAPPEAR. THE TAX MEASURES MIGHT EVEN INCLUDE THOSE INTRODUCED LAST SESSION IN THE TAX REFORM ACT OF 1983 (HR 4170), AFFECTING TAX-EXEMPT

CONFIDENTIAL

| ENTITY

ENTITY LEASING PROVISIONS, INSURANCE TAX PROVISIONS, MINOR TAX SIMPLIFICATION, FRINGE BENEFIT PROVISIONS AND POSSIBLY MORE CONTROVERSIAL PROPOSALS SUCH AS A FURTHER TIGHTENING UP ON INDUSTRIAL REVENUE BONDS. BUT THESE WOULD INCREASE REVENUE BY ONLY DOLLARS 2.5 BILLION IN FY85. TECHNICAL RE-ESTIMATES MIGHT ADD TO THE FY85 BUDGET SAVINGS SO THAT THEY MIGHT TOTAL DOLLARS 12 BILLION IN ALL.

5. THE PRESIDENT'S SUGGESTION THAT CONGRESSIONAL AND ADMINISTRATION REPRESENTATIVES SHOULD MEET TO AGREE A BIPARTISAN DEFICIT REDUCTION PLAN TO ACHIEVE A BUDGET REDUCTION OF DOLLARS 100 BILLION OVER THE NEXT THREE YEARS IS NOT A NEW APPROACH. BUT WHEN THIS PLOY HAS BEEN TRIED IN PAST YEARS, IT HAS BEEN AFTER THE PRESIDENT'S BUDGET HAS BEEN INTRODUCED AND DIFFICULTIES HAVE DELAYED ITS PROGRESS IN CONGRESS. THE PRESIDENT REFERRED TO THE 2,500 RECOMMENDATIONS OF THE GRACE COMMISSION ON COST CONTROL IN GOVERNMENT AS A CONTRIBUTION TO THE REDUCTIONS. THE COMMISSION CLAIMS TO HAVE IDENTIFIED A POTENTIAL DOLLARS 400 BILLION IN SAVINGS OVER THREE YEARS. BUT MOST OF ITS RECOMMENDATIONS CARRY LITTLE CONVICTION EITHER WITH THE OFFICE OF MANAGEMENT AND BUDGET OR ON THE HILL.

6. THERE HAVE FOR SOME TIME BEEN INFORMAL PROPOSALS FOR A PRESIDENTIAL COMMISSION TO MAKE RECOMMENDATIONS FOR CUTTING THE BUDGET DEFICIT IN THE MEDIUM-TERM. THE PRESIDENT DID NOT REFER TO THIS IDEA BUT INSTEAD PROPOSED THAT THE BIPARTISAN GROUP TO CONSIDER SAVINGS OVER THE NEXT THREE YEARS SHOULD ALSO EXPLORE HOW TO MAKE STRUCTURAL REFORMS. IT IS DIFFICULT TO SEE HOW SUCH A GROUP, THAT WILL BE HARD-PRESSED TO REACH AGREEMENT ON SHORT-TERM ISSUES, COULD REACH AGREEMENT ON A LONGER-TERM PLAN.

7. THE PRESIDENT'S BID FOR LINE-ITEM VETO POWER IN THE BUDGET PROCESS IS DESIGNED TO REPLACE THE PRESENT ALL OR NOTHING VETO WHICH IS A VERY BLUNT INSTRUMENT. ADOPTION OF A LINE-ITEM VETO POWER COULD IN THEORY BE ACHIEVED EITHER WITH LEGISLATION OR (MORE EFFECTIVELY) BY A CONSTITUTIONAL AMENDMENT. BUT IN PRACTICE IT IS DOUBTFUL WHETHER CONGRESS WOULD ACCEPT EITHER, SINCE SUCH A MEASURE WOULD GIVE THE PRESIDENT POWER TO CUT OUT SPECIFIC ITEMS THAT HE DID NOT LIKE WHILE LEAVING THE REST. HOWEVER A LINE-TERM PROCEDURE, IF ADOPTED, WOULD BE LIMITED IN EFFECT. IT COULD NOT GIVE THE PRESIDENT A VETO OVER THE BASIC PROVISIONS OF PUBLIC LAW. IT WOULD NOT FOR EXAMPLE TOUCH THOSE PROVISIONS WHICH GIVE CITIZENS ENTITLEMENTS UNDER PROGRAMMES SUCH AS SOCIAL SECURITY AND MEDICARE WHERE THE SCOPE FOR PUBLIC EXPENDITURE REDUCTIONS IS THE GREATEST. SUCH A VETO WOULD ALSO HAVE THE DISADVANTAGE OF IMPEDING BIPARTISAN DEALS, SUCH AS THE ONE SOUGHT BY REAGAN THIS YEAR, UNLESS THE PRESIDENT PROMISED NOT TO APPLY HIS VETO TO THE RESULT. BUT THE PRESIDENT HAS EVIDENTLY ADOPTED THE LINE-ITEM VETO AS HIS MAIN OBJECTIVE IN CHANGING THE BUDGET PROCESS: IT WAS NOTICEABLE THAT LAST NIGHT HE DOWN-PLAYED HIS LONG-STANDING ADVOCACY OF A CONSTITUTIONAL AMENDMENT REQUIRING A BALANCED BUDGET.

CONFIDENTIAL²

CONFIDENTIAL

8. THE MAJOR NEW ELEMENT IN THE SPEECH WAS THAT THE PRESIDENT HAS ASKED TREASURY SECRETARY REGAN TO REFORM AND SIMPLIFY THE ENTIRE US TAX CODE AND TO REPORT BACK IN DECEMBER 1984. THIS WILL BE A MONUMENTAL TASK. THE PRESIDENT TALKED IN TERMS OF LOWER TAX RATES ENCOURAGING TAX COMPLIANCE BY THE ILLEGAL UNDERGROUND ECONOMY, TO INCREASE THE TAX BASE, WHEREAS SECRETARY REGAN HAS RECENTLY BEEN ADVOCATING THE REMOVAL OF LEGITIMATE TAX LOOP-HOLES WITH THE SAME OBJECTIVES AS THE PRESIDENT - ENABLING MARGINAL INCOME TAX RATES (AND PROGRESSIVITY) TO BE REDUCED WITHIN THE US TAX SYSTEMS. BUT THE MAJOR AMERICAN PERSONAL TAX DEDUCTIONS - INTEREST PAYMENTS, CHARITABLE CONTRIBUTIONS, AND MEDICAL EXPENSES - WOULD BE DIFFICULT TO REDUCE. THE PRESIDENT MOREOVER DID NOT ADD TO THE CREDIBILITY OF ANY PROGRAMME TO CLOSE PERSONAL TAX LOOPHOLES BY REITERATING HIS SUPPORT FOR TUITION TAX CREDITS FOR PRIVATE SCHOOL EDUCATION.

9. FCO PLEASE PASS TO BOTTRILL (TREASURY), GREEN (BANK) AND BROADBENT (ESID).

WRIGHT

ADVANCED AS REQUESTED

FCO | WH
NAD

COPIES TO
ADVANCE ADDRESSEES