RESTRICTED

US file

AT to see

SAVING TELEGRAM

BY BAG [CULL]

FROM WASHINGTON

TO FCO TELEGRAM No.11 SAVING OF 25 APRIL 1984

OUTLOOK FOR THE US BUDGET DEFICIT: CHIEF SECRETARY'S VISIT TO WASHINGTON

Summary

1. During his visit to Washington on 17-18 April, the Chief Secretary had discussions with US officials about the prospects for reductions in the US budget deficit. The consensus was that this year's deficit reduction package, aimed at saving \$150 bn over three years, would pass through the Congress but that the Administration would still face the prospect of \$175-\$200 bn deficits after the November elections. The outlook for further deficit-cutting measures in 1985 depended on the outcome of the elections, but the most likely source of savings was some reduction in the planned growth of defence expenditure. The prospects for radically increasing taxes or substantially reducing entitlement expenditure would probably continue to be difficult, or at best uncertain, in 1985.

Detail

2. On 17-18 April Mr Rees had a number of discussions with US officials about various aspects of the Federal budget during calls on Stockman (Director, Office of Management and Budget), Sprinkel (Under Secretary for Monetary Affairs at the US Treasury), Davis (Administrator of Health Programmes at HHS), Devine (Director, Office of Personnel Management), Chapoton (Assistant Secretary for Tax Policy, US Treasury), Penner (Director, Congressional Budget Office) and Bowsher (Comptroller General).

3. Stockman frankly stated that, even if this year's deficit reduction package of \$150 bn in savings over three years were fully implemented, a re-elected Administration would still be faced with \$200 bn deficits running throughout the next five years. The main reason for this pessimistic view was that the Administration's official forecasts had almost certainly under-estimated the average level of interest rates, and over-estimated GNP growth, over the five-year budget period. While Penner believed that the successful enactment of the deficit reduction package would have a major psychological impact on attitudes in the Congress, and would save a considerable amount of debt interest, he too saw deficits staying in the \$175-\$200 bn range even after its passage.

4. All the Chief Secretary's interlocutors agreed that it was probable that the deficit reduction package would be passed, although most pointed out that there was a sizeable gap to be bridged between the Democratic House and the Republican Senate on the desirable rate of growth of defence spending. The most

/plausible

RESTRICTED

plausible explanation for the apparent cooperativeness of the Democratic Party on the package was given to the Chief Secretary by Mr Art Pine of the Wall Street Journal at his lunch with financial journalists: the Democrats had decided that it would improve their electoral prospects if they did not treat the deficit as a divisive or party-political issue.

5. The convergence of opinion about the prospects for the deficit reduction package was however not paralleled by any consensus about the post-election prospects for deficit reduction. Sprinkel, who was optimistic, saw these mainly in terms of legal or Constitutional reforms that would give the President the power to veto individual items of expenditure voted by the Congress and that would require a balanced budget except in national emergencies. He was not keen to raise taxes as it could, by taking the deficit pressure off, encourage the Congress to spend more and anyway his own objective was to reduce the public expenditure/GNP ratio rather than the deficit itself..

6. Stockman, on the other hand, made no reference to legal devices and was under no illusion that it would be easy to make massive cuts in social entitlement programmes, and both he and Penner pointed to the high amount of defence expenditure in the next few years that was already contractually committed. Some progress might be made towards partially de-indexing social benefits or delaying their payment, but this would only reduce the budget deficit marginally. By implication, Stockman obviously thought tax increases were necessary to make a major difference, but stopped short of openly advocating them.

7. Davis pointed out that cash expenditure on the Medicare programme was growing at the alarming annual rate of 15-16% and Penner said that total health expenditure was growing at an annual rate of 12%, and that there was stiff political resistance to reforms. Penner was also concerned about the rising burden of debt interest and had little confidence about the permanence of efforts to contain agricultural support expenditure. He did however apparently believe that the will shown by the Congress to do something about the deficit this year might extend beyond the elections. Devine gave the impression that his attempts to reform the US Civil Service pension, health, and life insurance systems would be opposed in the Congress - and these he thought were some of the major potential sources of savings in administrative expenditure. No official gave any indication that it would be possible - as Secretary Regan suggested it would to the Chancellor of the Exchequer in the previous week - to reduce the deficit, mainly through expenditure reductions, to 1/2% of GNP by 1990.

8. No officials said that they expected tax increases after the elections.

Comment

9. The US will still be faced with $175 - $200 bn deficits after the November electiions. There is traditionally a brief period - perhaps the first six months after a President is re-elected - when

/he

he can be expected to have the sympathy of the Congress and the benefit of the doubt concerning his proposals. But even so, proposals for the de-indexation of Social Security benefits or significant savings in health care programmes (as are being advocated by some Republicans in Congress) could only pass through a Congress that was much more Republican than the present one, and the general expectation is for a more Democratic Congress after November. Reductions in the growth of defence expenditure are much more likely, but this will be limited by what the President can accept and the extent to which defence expenditure is already contractually committed. Defence savings would build up over a period of years. It has been estimated by Pechman of Brookings that savings of $50 bn might be feasible in 1989, although in FY86 the potential savings would be far smaller. The constitutional and legal reforms to control expenditure mentioned by Sprinkel would be exceedingly difficult to implement.

10. On the tax side, tax reform is being considered, but not in the context of raising revenue - though as the US Treasury privately admit, it would not be technically difficult to convert the measures now under consideration in that Department from revenue neutrality to revenue raising. The President is against raising the rates of existing taxes, and his objections might well extend to introducing new taxes to raise revenues. He has said however that he is ready to contemplate closing tax loopholes. While some thought is being given in Congress and in the Treasury to a flat-rate income tax, a consumption tax and a VAT, there are no signs that detailed studies are under way in the Treasury about how to close major tax loopholes. The major Federal tax expenditures that could be reduced - interest relief for individuals, deductions for State taxes and charitable contributions, exemption of Social Security payments from income tax - all have special interest groups waiting to pounce should the Administration propose changes affecting them. The prospects for the closing of loopholes seem to depend largely on developments in the Congress next year, which are highly uncertain.

WRIGHT

THIS TELEGRAM WAS NOT ADVANCED

FINANCIAL

ESID

NAD