Mr Turnbull.

~~2/5~~

1 ~~Bartlett~~
2. CF
3 US file

Treasury Chambers, Parliament Street, SW1P 3AG

Roger Bone Esq
Private Secretary to
Foreign Secretary
Foreign & Commonwealth Office
Downing Street
LONDON
SW1A 2AL

30 April 1984

Dear Roger

As you know, the Chief Secretary visited Washington on 17 and 18 April. I attach notes of the meetings he attended. They may be of interest to your Minister and some of your officials.

I am also sending copies of the notes of meetings with Stockman, Sprinkel, and Penner to John Bartlett and Andrew Turnbull, of the meetings with Olmer and Draper, to Steve Nicklen, the note on health expenditure to Steve Godber, and the notes on Bowsher and Devine to Mary Brown.

Yours sincerely

John Gieve

JOHN GIEVE
Private Secretary

US BUDGET: NOTE OF A MEETING BETWEEN THE CHIEF SECRETARY AND DAVID STOCKMAN, DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET IN WASHINGTON ON 18 APRIL 1984

Present: Mr Stockman
Mr Valentine

Chief Secretary
HM Ambassador
Mr Wicks
Mr Gieve

Mr Stockman introduced the discussion by handing round a set of graphs (attached) and giving a brief commentary on them. Table 1 contracted the Budget deficits for the next four years projected on the basis of the President's Budget proposals and the revised proposals based on a "down payment" of $141 billion.
However he pointed out that these figures were based on very optimistic assumptions about interest rates (Table 2) and growth. (Tables 3, 4 and 5 show that while the recovery in

exactly matched the post war average for the first 5 recovery quarters, the assumption for the future implied a recovery longer and stronger than all but one of the post-War cycles). Allowing for rather more realistic assumptions, Mr Stockman said that even after the "down payment" the US faced deficits of around $200 billion a year for several years. To that should be added $10 to 15 billion for off-Budget items. This year, the Federal deficit was offset to some extent by surpluses in the States. He said these surpluses reflected first a change in funding of pension schemes which was not relevant and second the fact that the States had underestimated the strength of the recovery and had therefore raised taxes and cut expenditure by more than had been necessary to hold their deficits down. They were likely to reverse these restraints in the coming year.

2. Tables 7 to 12 dealt with trends in expenditure since 1954. They illustrated that expenditure on domestic programmes had been broadly stable since 1981 with a marked reduction in discretionary spending, broad stability in means-tested welfare spending, and some increase in social insurance (including Medicare) and retirement benefits. On the other hand there had been a massive increase in "security assistance, economic aid, and defence-related" and more important in defence spending itself. The trend in defence spending shown on page 11 would not be much affected by the cuts of being considered by the Democrats as part of the "down-payment". At the most \$20 to 30 billion was at stake there. Mr Stockman said that major reductions would not be possible in the next few years since expensive systems had been ordered and started. They were pretty well "locked in" to the increases shown. He pointed to the massive increase in the debt service burden both in absolute terms and as a percentage of GNP (see page 12).

3. The figures on pages 13 to 18 illustrate past trends in the General Government Budget (ie. excluding social insurance) and the Social Insurance Budget and the prospects for the next few years on a "current services" basis. In broad terms this showed that general Government expenditure was expected to remain around 16% of GNP as it had been since 1955 but that general Government taxes on the current basis had been reduced markedly in 19[illegible]3 and would remain around [illegible] unless something was done. On the social insurance side there had been an increase in expenditure as a share of GNP from [illegible] settle at around 7½% by 1990 and that by that time it would be broadly matched by contributions.

4. Finally, looking at the deficit, Table 1[illegible] contrasts the deficit as a share of GNP on the President's proposals and on a current services basis. Mr Stockman did not elaborate what

was intended by "current services" but I assume that it meant maintaining the value of benefits, tax thresholds etc. but that the projections were based on the same [illegible] assumptions about interest rates and growth on which he had commented earlier.

5. In discussion, <u>Mr Stockman</u> commented on the scope for reducing the deficit further. The basic problem he explained was that the Congress did not want to cut spending and the President did not want to increase taxes. Further he indicated that in the President's eyes the spending problem was entirely on the domestic side. <u>Mr Stockman</u> said that there was no prospect of abolishing benefits or taking head on existing entitlements. They had tried, for example, to raise the early retirement age from 62 to 65 but had been forced to withdraw their proposal (although he mentioned that they had passed an act increasing the retirement age from 65 to 67 with a transition timed for the years 2003 to 2021). They had had more success in halting the growth in the Disability Budget by tightening up the administration. They had got the Congress to agree to a case by case review and as a result 192,000 people had had their entitlements cancelled. Medicare was still not under control but the change from cost plus to fixed pricing (ie for various specified sorts of treatment) would put pressure on the Health Services to reduce length of stay, ancilliary services and so on. They had also introduced taxation on Social Security benefits above $25,000 a year.

6. <u>Mr Stockman</u> claimed some success also in reducing the Federal Pay Bill - not by reducing numbers which had broadly been maintained but by holding pay increases 2% below inflation year by year since 1978. He said that this had been possible [illegible] the administration could impose a pay cap and could veto a [illegible] move to overspend the limit. In both Agriculture and Defence, he said that [illegible] made a costly mistake in forecasting inflation. They had de-indexed price support in Agriculture in 1981 and provided for cash increases which had been intended to [illegible], had in fact increased it massively. They had not then been able to overturn their original figures. As a result production had

increased massively. The legislation on price support came up for review in 1985; they President was hostile to the whole programme but there was a very strong lobby among Republicans in the Congress. On Defence, they had agreed figures in 1981 intended to provide for 12% real growth in 1981-82 and 7% real growth thereafter. Again the cash figures had reflected to gloomy a view on inflation and it had been impossible to get Congress to reduce the cash figures accordingly.

7. <u>Mr Stockman</u> was interested in the privatisation programme in Britain and the sales of Council Houses. He said that the Federal contribution to low income housing had been greatly reduced although this did not appear in the Budget figures. In the past the system had been to guarantee to meet for up to 30 years the difference between the costs of supplying low income housing and the fair rents paid by tenants. They changed this to a system of means-tested vouchers and had been able to restrict payments of these to some 10 million recipients out of a total eligible group of 25-30m. The mechanism of limitation had been borrowed from the earlier scheme under which only 100,000 new housing units a year could be subsidised. This rule had been transferred and now applied to numbers of households receiving vouchers.

8. For the future, <u>Mr Stockman</u> said that the administration would introduce new expenditure proposals after the Election. These would attempt to squeeze expenditure at the margin and would probably include a delay or reduction in the Cost of Living adjustment to Social Benefits. He mentioned a figure of 1½% a year. He did not discuss the tax position but his assessment of the expenditure prospect made plain why he has [illegible]

9. Three other points came up in discussion:

a. <u>Cash Planning</u>; <u>Mr Stockman</u> said that they would like to plan in cash but since the Budgetary process was controlled in Congress they could [illegible] of "Budget authorities" for particular projects which ran over a number of years and could be in constant prices.

b. Infrastructure; Mr Stockman said there had not been great pressure in this recession for extra investment in public infrastructure. This reflected in part the fact that the most spending on infrastructure was the responsibility of the States. However, it also reflected the view in the Democrat party - following the 1975-76 Public Works Programme-that such programmes could not be used successfully to counter cyclical downturns because of lags, because they drew in the wrong people and for other reasons.

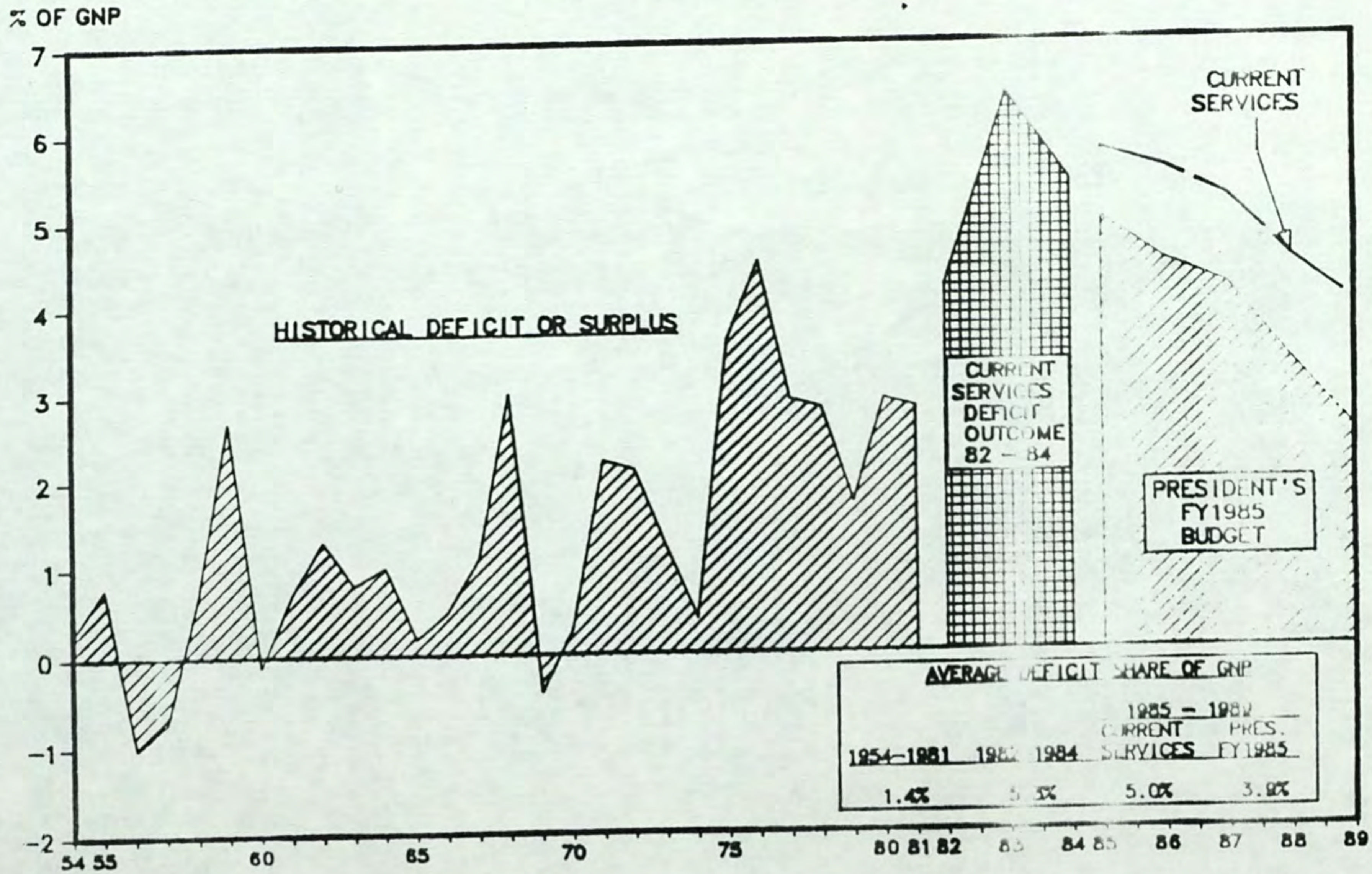
c. Value for Money; Mr Stockman said that most of the areas of expenditure where efficiency of management and so on was vital were the responsibility of the States. The exception was Defence but here the size of the programme was so vast that the OMB were not able to get a grip on it.

JG

JOHN GIEVE

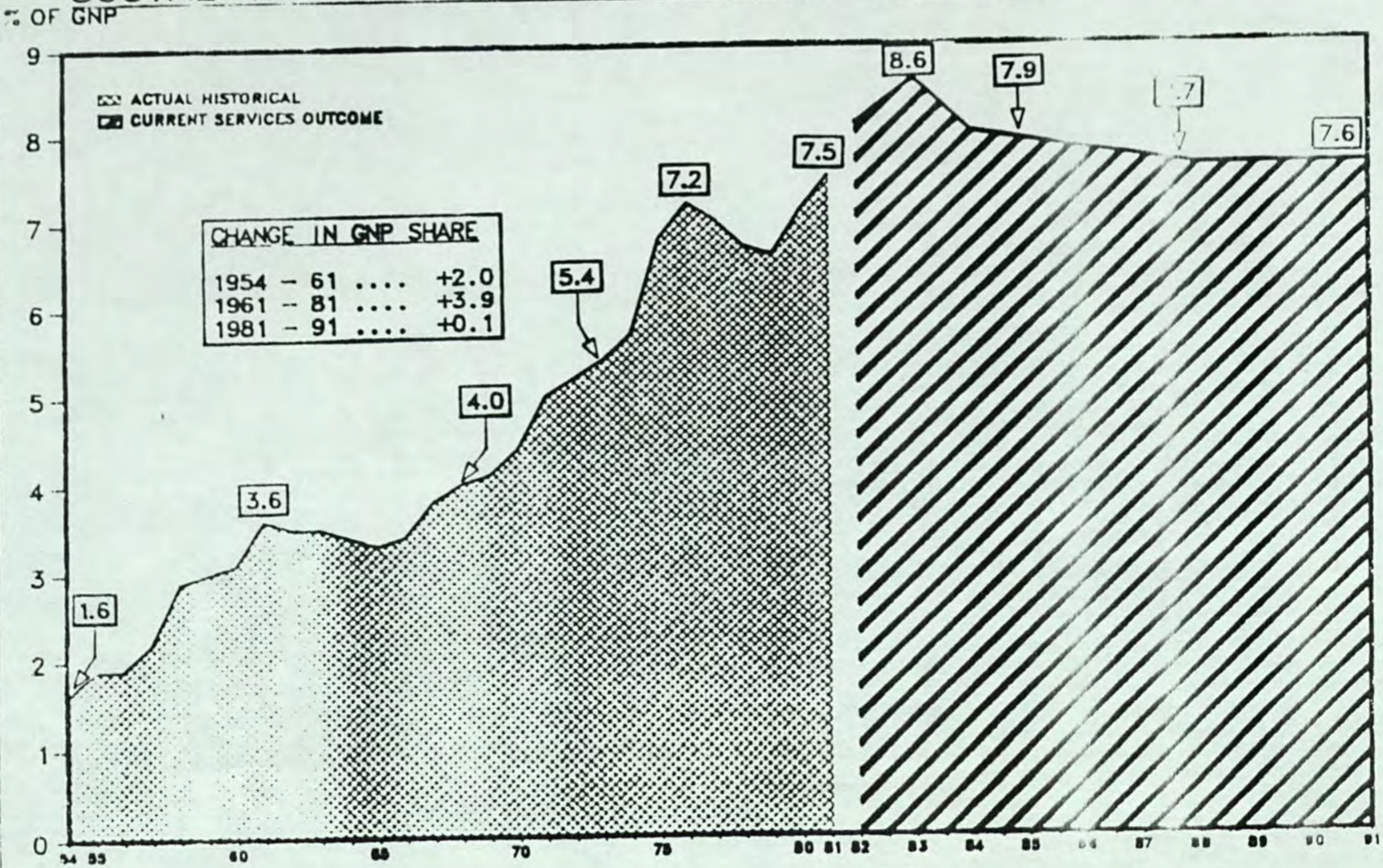
cc PPS
Financial Secretary
Economic Secretary
Minister of State
[illegible]
Mr Bailey
Mr Littler
[illegible]
Mr Cassell
Mr Unwin
Mr Anson
Mr Scholar
Mr Lavelle
Mr Lankester
Mr Battishill
Mr Evans
Mr Odling-Smee
Mr Bottrill
Mr Sedgwick
Mr P Gray
Mr Ridley
Mr Lord
Mr Portillo
Mr Walsh (UK Embassy)

DEFICIT* SHARE OF GNP IN HISTORICAL PERSPECTIVE



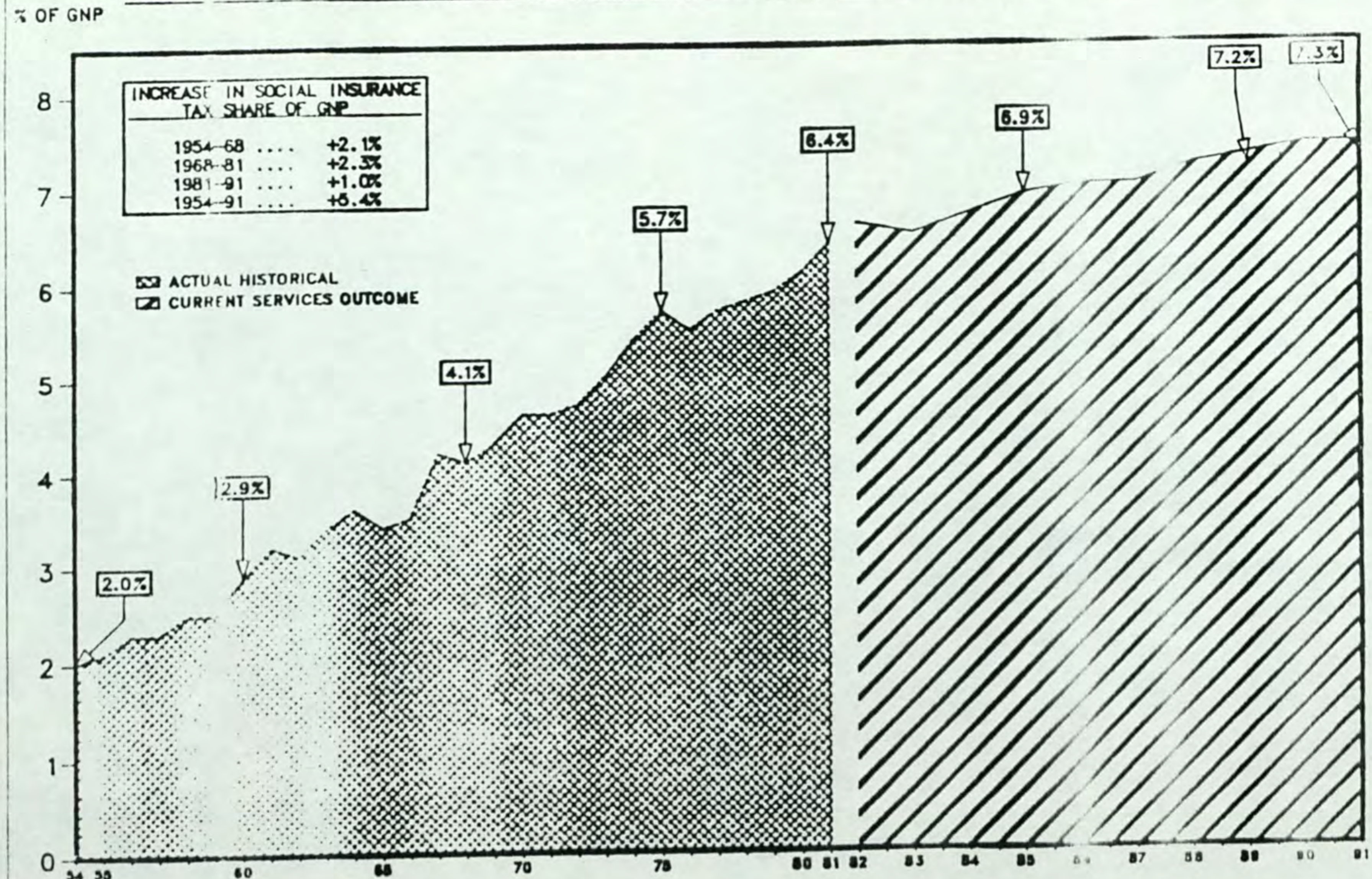
THE TALE OF TWO BUDGETS:

SOCIAL INSURANCE BUDGET AS SHARE OF GNP, 1954 - 1991



THE TALE OF TWO BUDGETS;

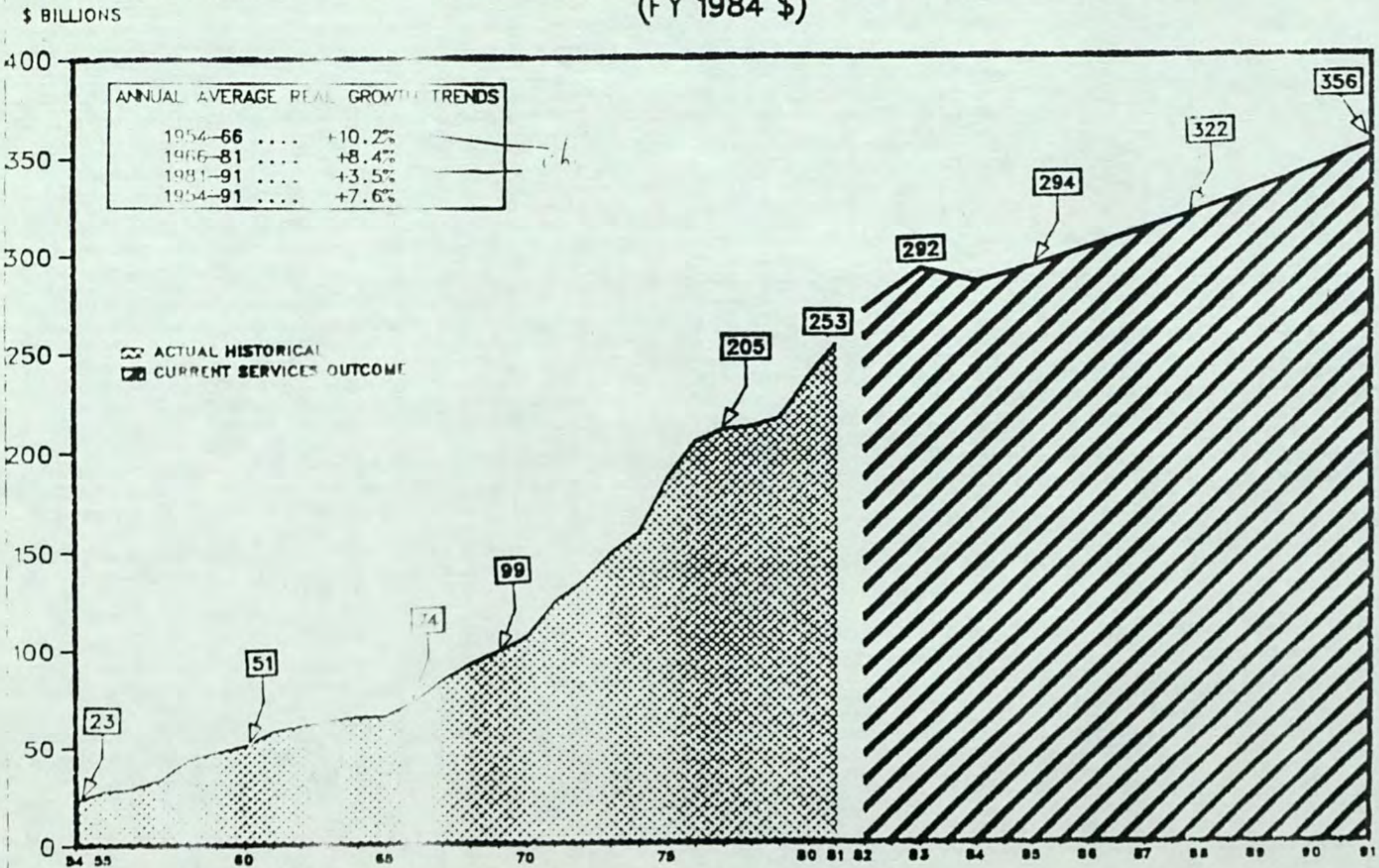
SOCIAL INSURANCE TAXES AS SHARE OF GNP, 1954 - 1991



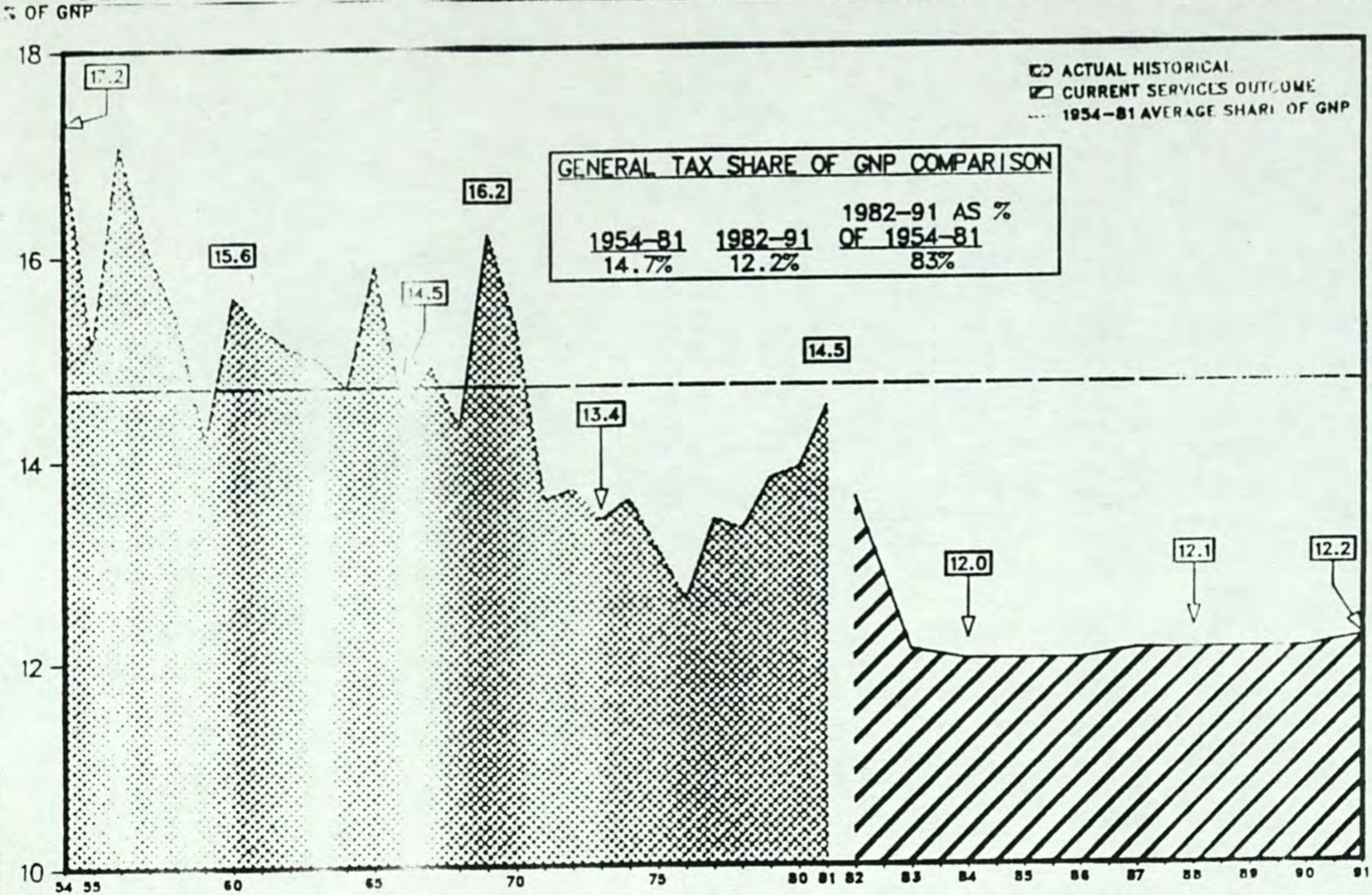
THE TALE OF TWO BUDGETS:

CONSTANT DOLLAR SOCIAL INSURANCE BUDGET, 1954 – 1991

(FY 1984 $)

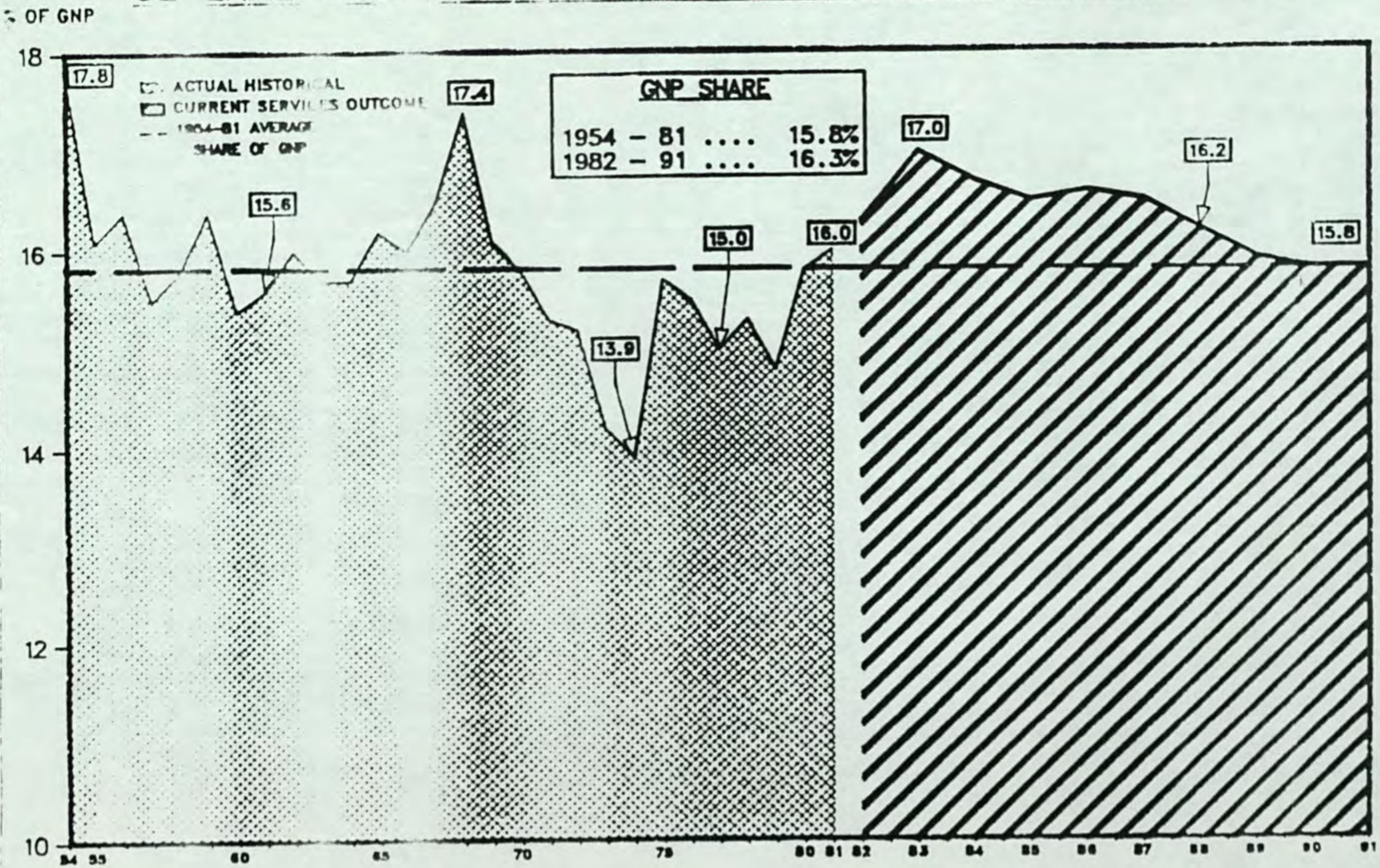


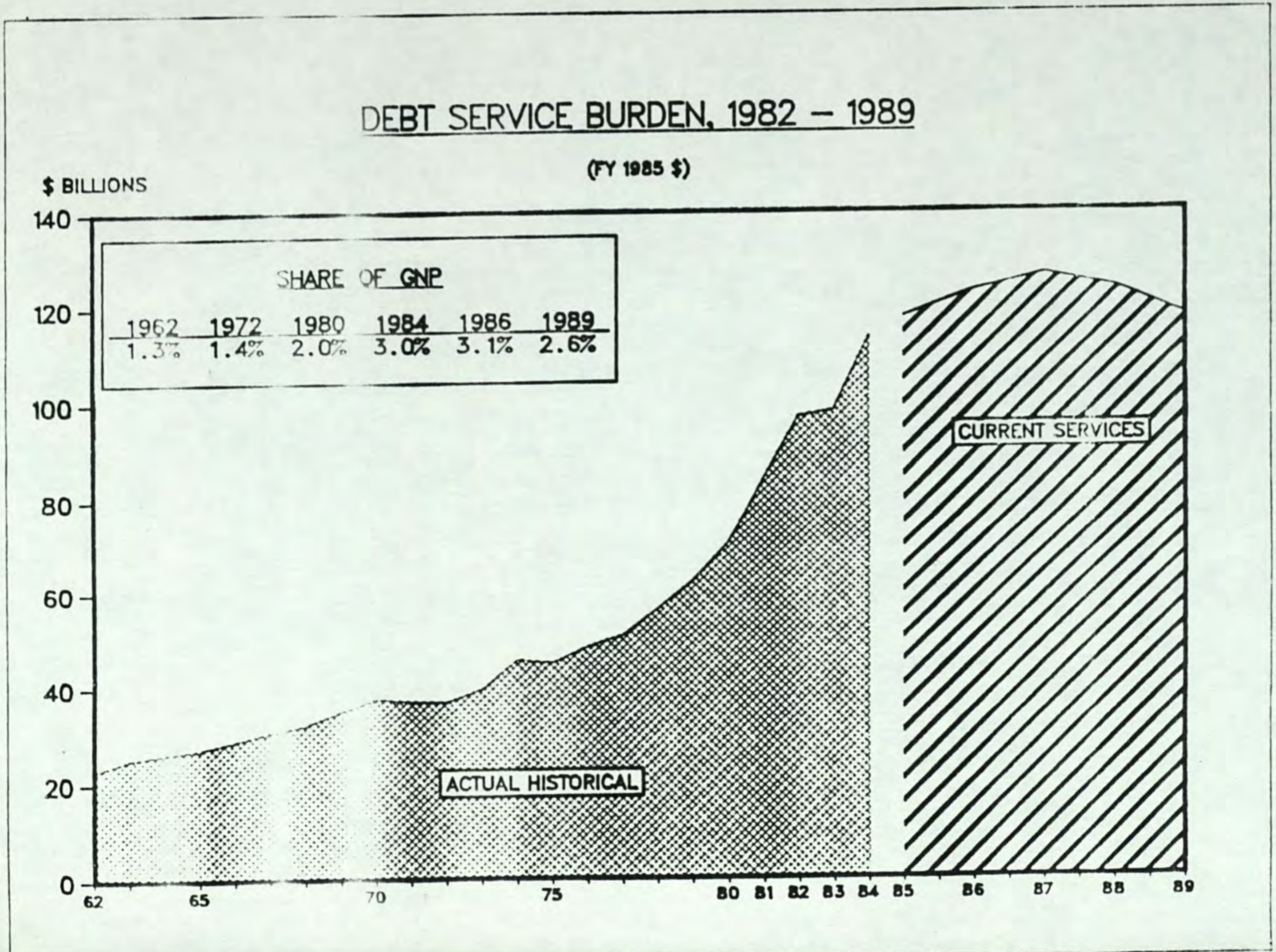
THE TALE OF TWO BUDGETS:
GENERAL GOVERNMENT TAXES AS SHARE OF GNP 1954 - 1991



GENERAL TAX SHARE OF GNP COMPARISON		
1954-81	1982-91	1982-91 AS % OF 1954-81
14.7%	12.2%	83%

THE TALE OF TWO BUDGETS:
GENERAL GOVERNMENT BUDGET AS SHARE OF GNP, 1954 – 1991

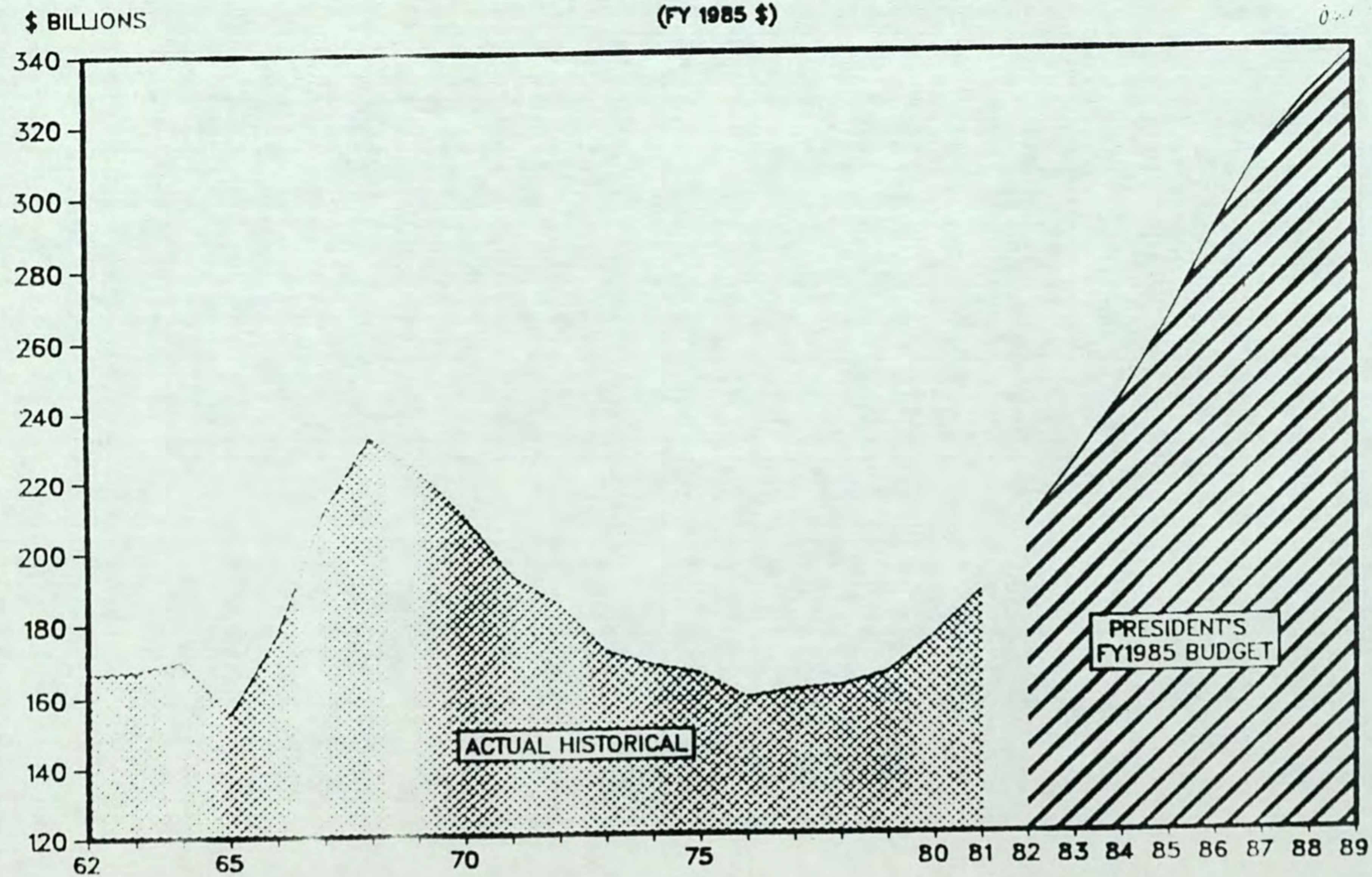


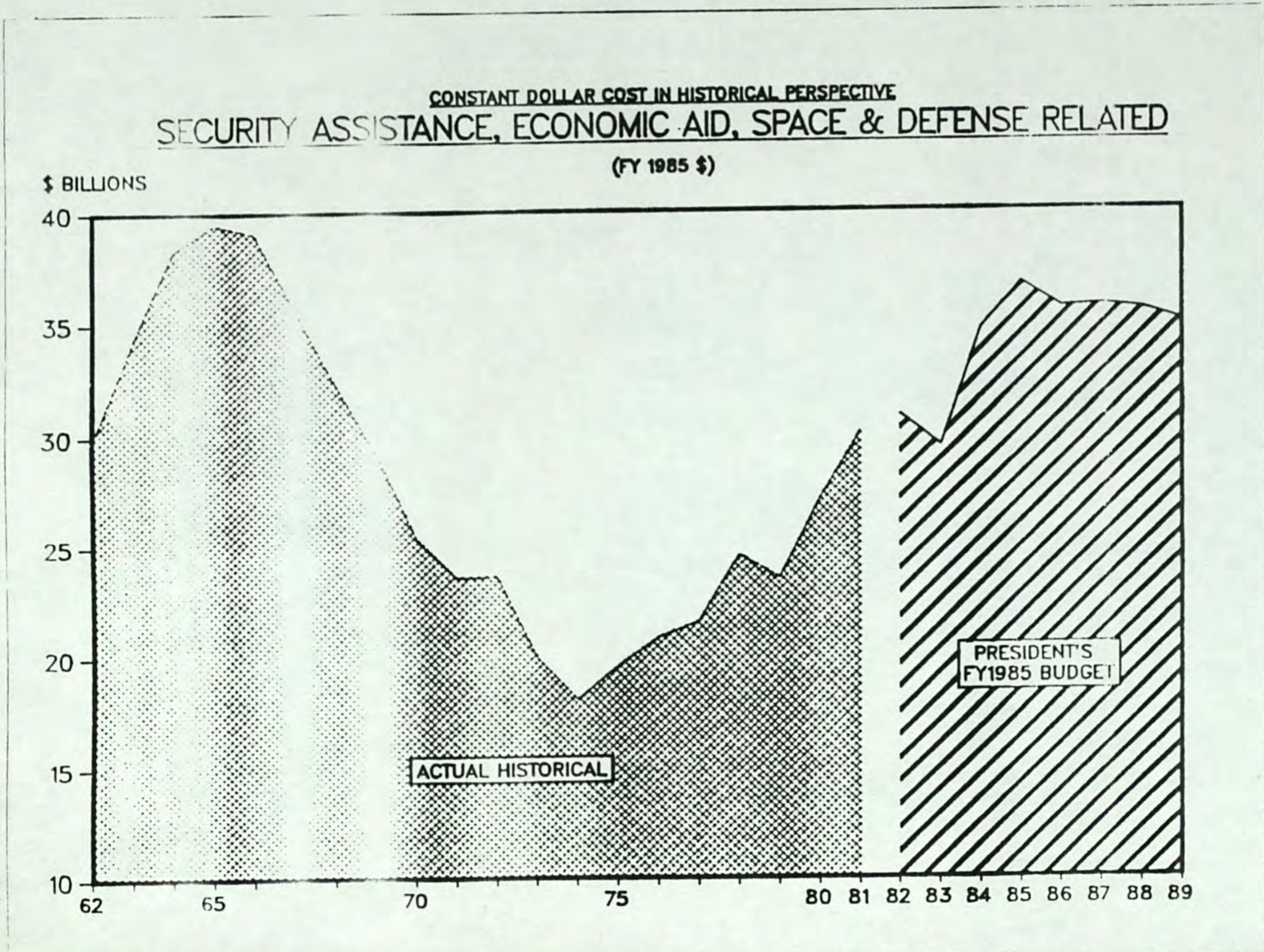

DEBT SERVICE BURDEN, 1982 - 1989
(FY 1985 $)
$ BILLIONS
140
120
100
80
60
40
20
0
SHARE OF GNP
1962 1972 1980 1984 1986 1989
1.3% 1.4% 2.0% 3.0% 3.1% 2.6%
CURRENT SERVICES
ACTUAL HISTORICAL
62 65 70 75 80 81 82 83 84 85 86 87 88 89

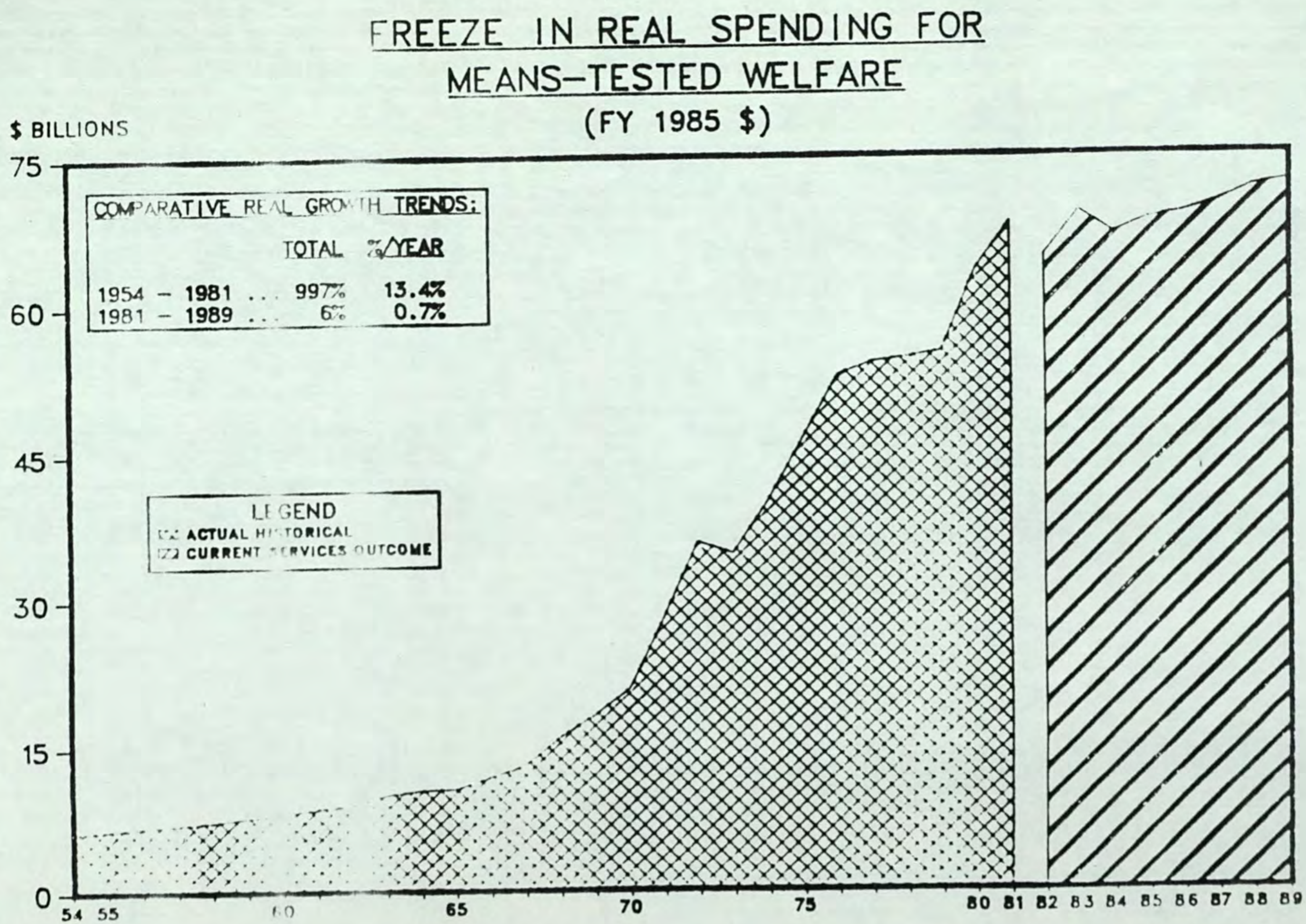
CONSTANT DOLLAR COST IN HISTORICAL PERSPECTIVE

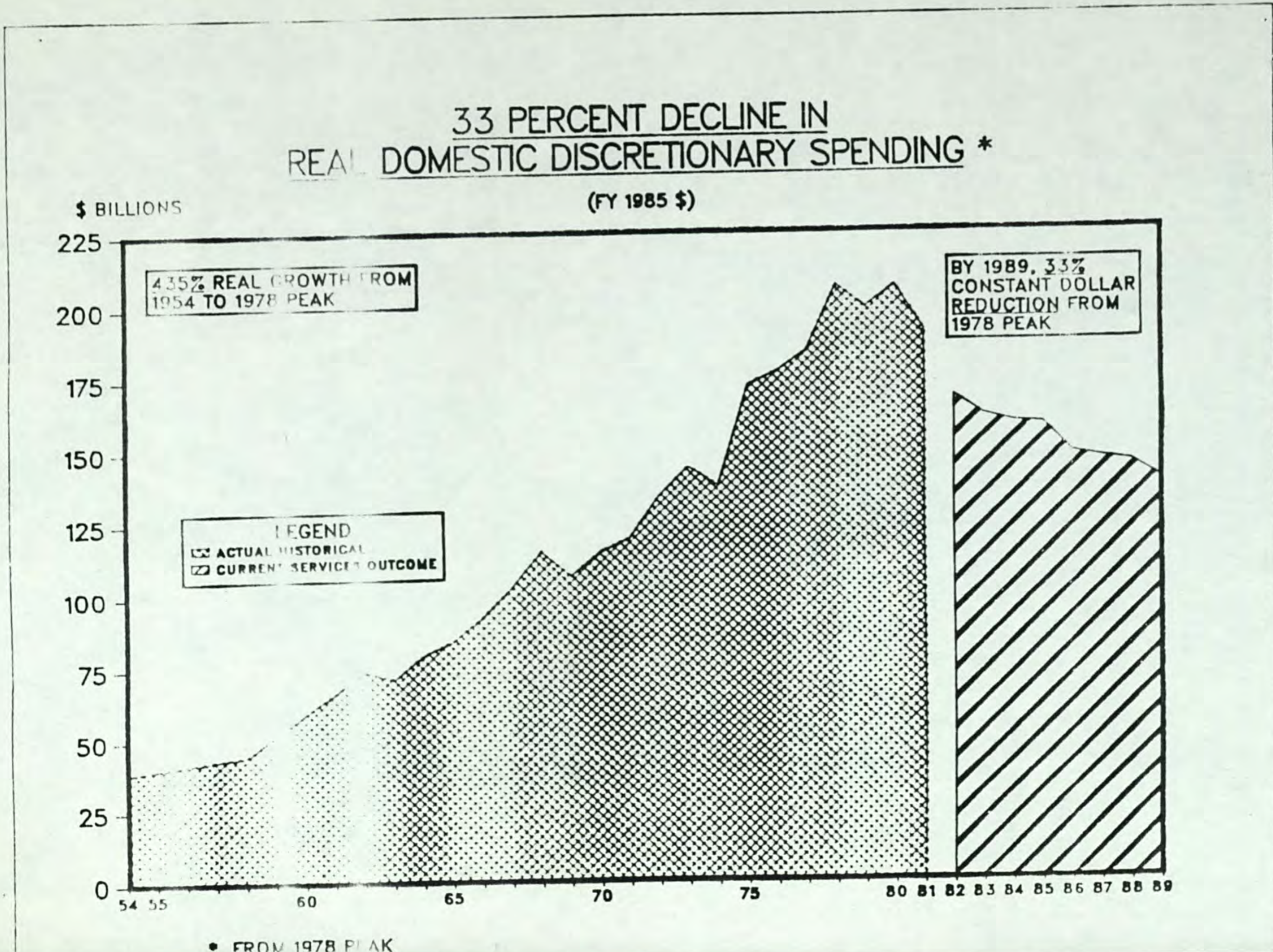
DEPARTMENT OF DEFENSE

(FY 1985 $)



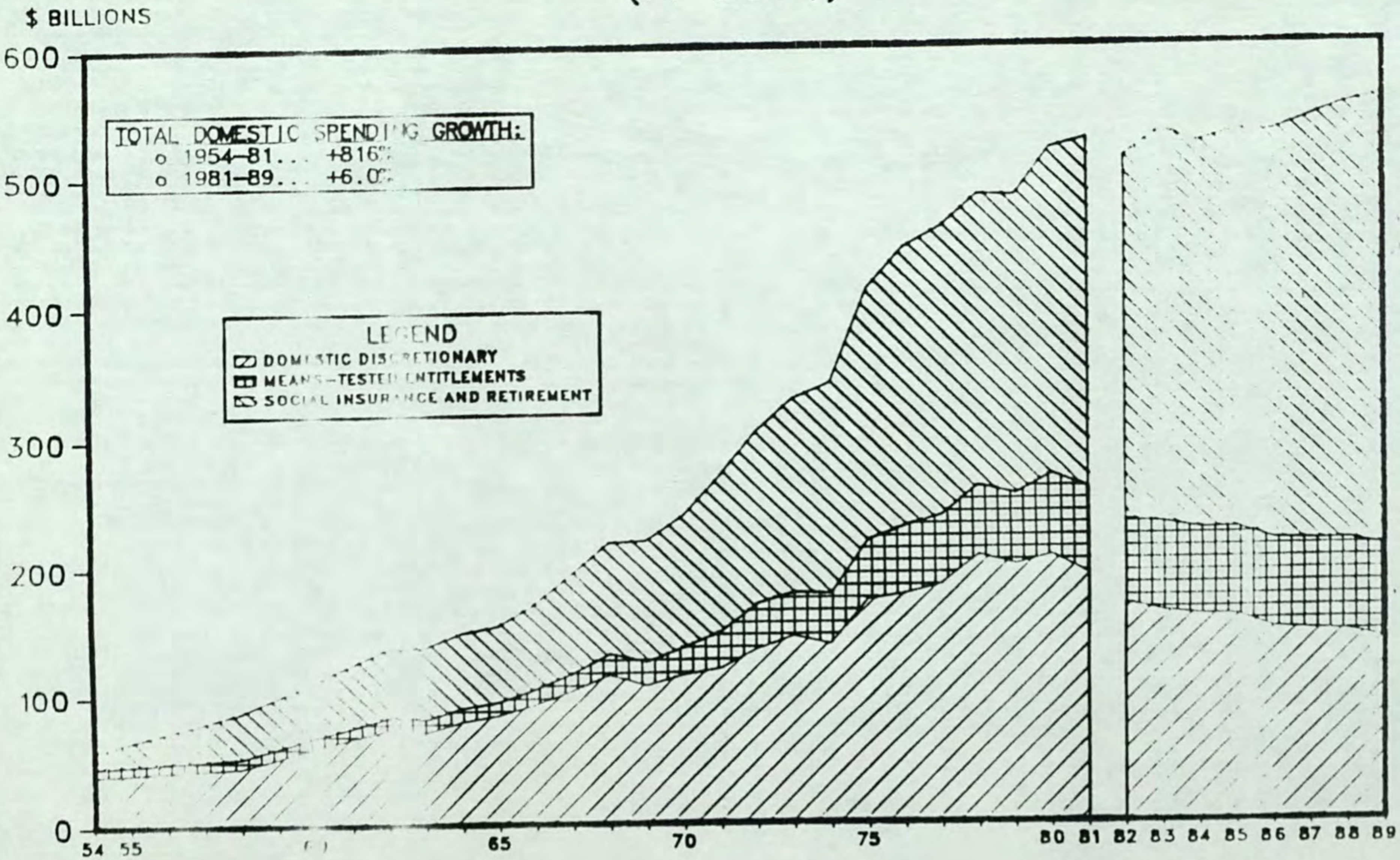

CONSTANT DOLLAR COST IN HISTORICAL PERSPECTIVE
SECURITY ASSISTANCE, ECONOMIC AID, SPACE & DEFENSE RELATED
(FY 1985 $)
$ BILLIONS
40
35
30
25
20
15
10
62
65
70
75
80
81
82
83
84
85
86
87
88
89
ACTUAL HISTORICAL
PRESIDENT'S
FY1985 BUDGET

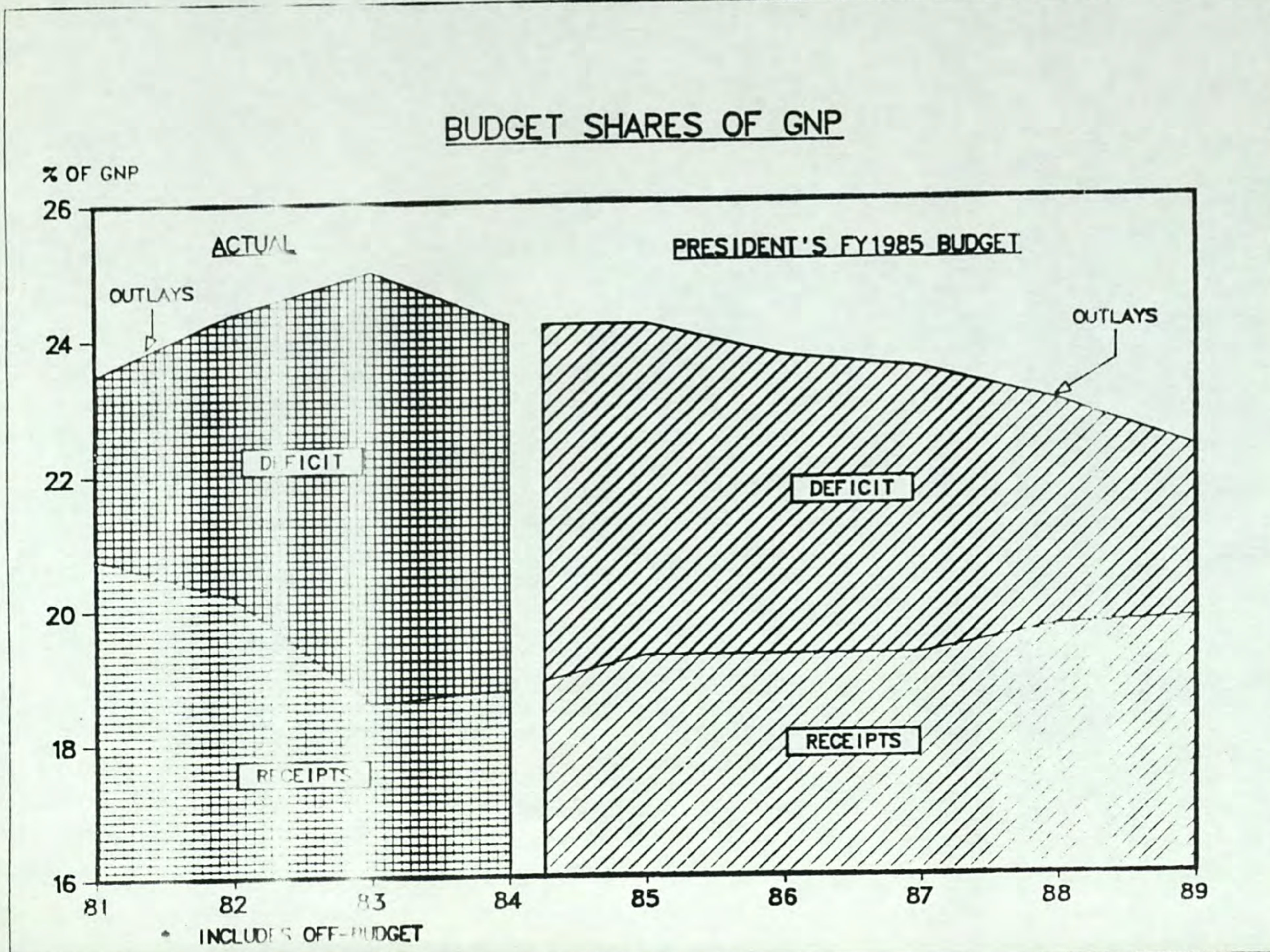

FREEZE IN REAL SPENDING FOR MEANS-TESTED WELFARE
(FY 1985 $)
$ BILLIONS
75
60
45
30
15
0
COMPARATIVE REAL GROWTH TRENDS:
TOTAL %/YEAR
1954 - 1981 ... 997% 13.4%
1981 - 1989 ... 6% 0.7%
LEGEND
ACTUAL HISTORICAL
CURRENT SERVICES OUTCOME
54 55 60 65 70 75 80 81 82 83 84 85 86 87 88 89


33 PERCENT DECLINE IN
REAL DOMESTIC DISCRETIONARY SPENDING *
(FY 1985 $)
$ BILLIONS
225
200
175
150
125
100
75
50
25
0
435% REAL GROWTH FROM 1954 TO 1978 PEAK
BY 1989, 33% CONSTANT DOLLAR REDUCTION FROM 1978 PEAK
LEGEND
ACTUAL HISTORICAL
CURRENT SERVICES OUTCOME
54 55 60 65 70 75 80 81 82 83 84 85 86 87 88 89
* FROM 1978 PEAK

NEARLY ZERO REAL GROWTH IN TOTAL DOMESTIC SPENDING

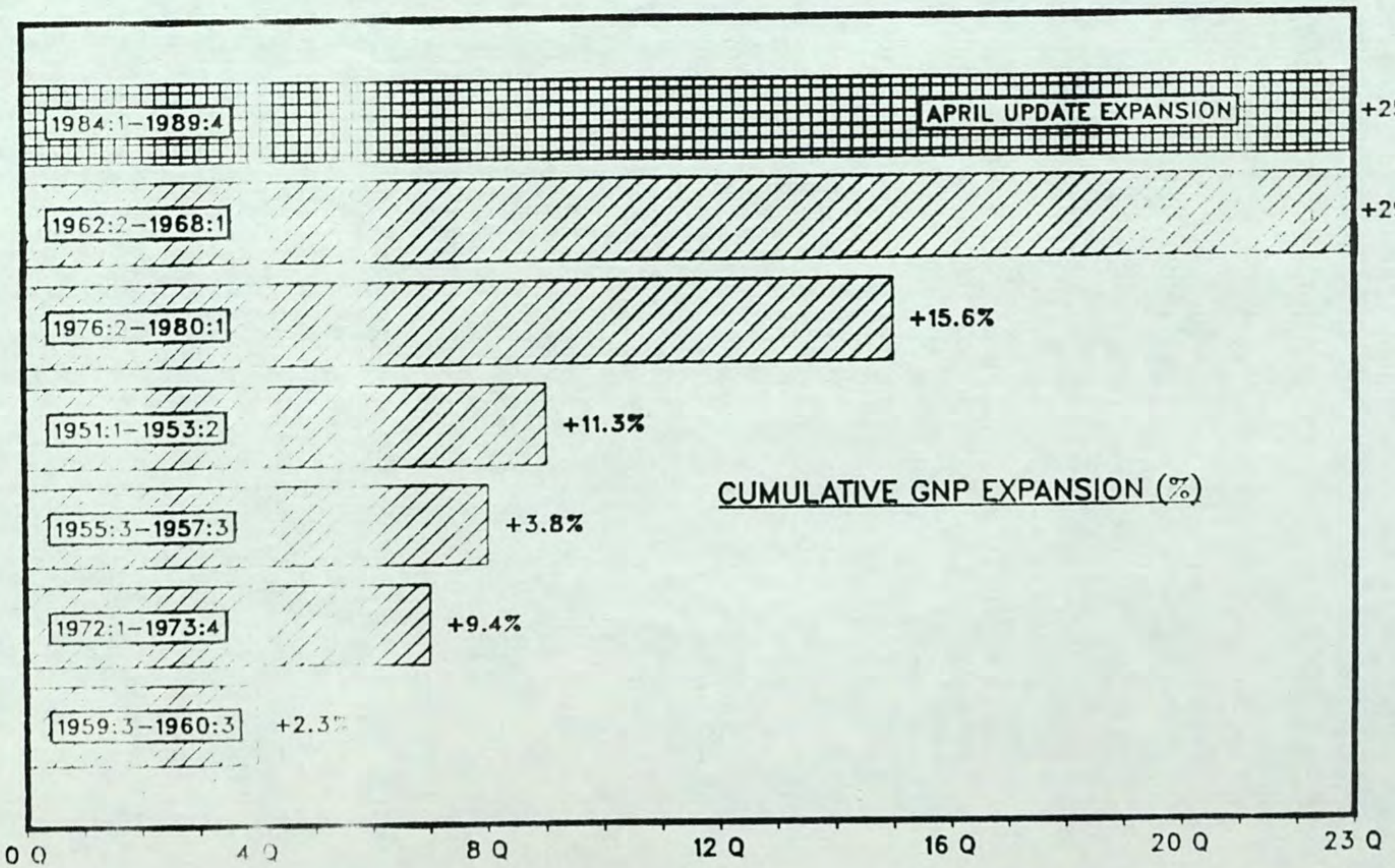
(FY 1985 $)

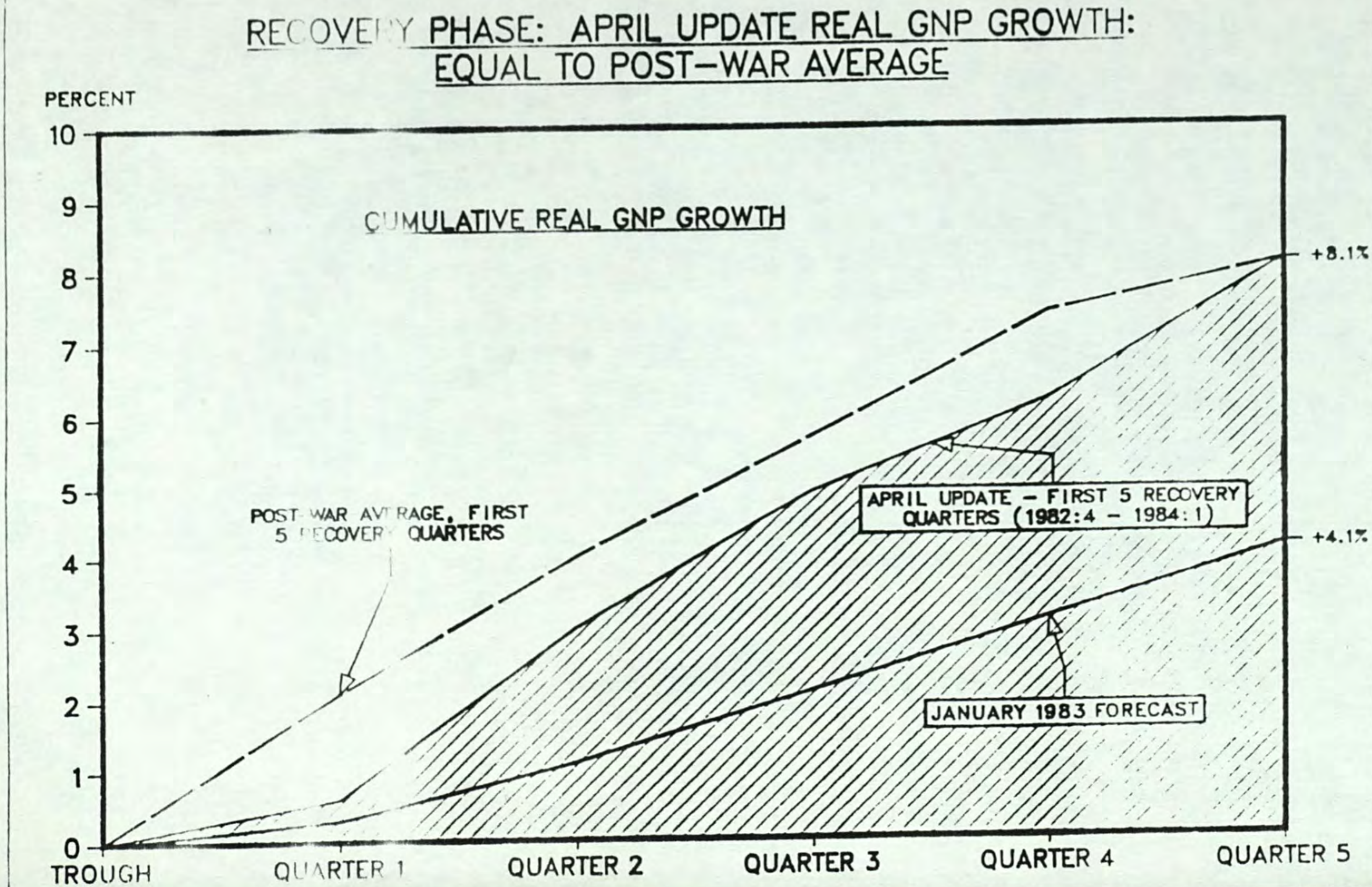


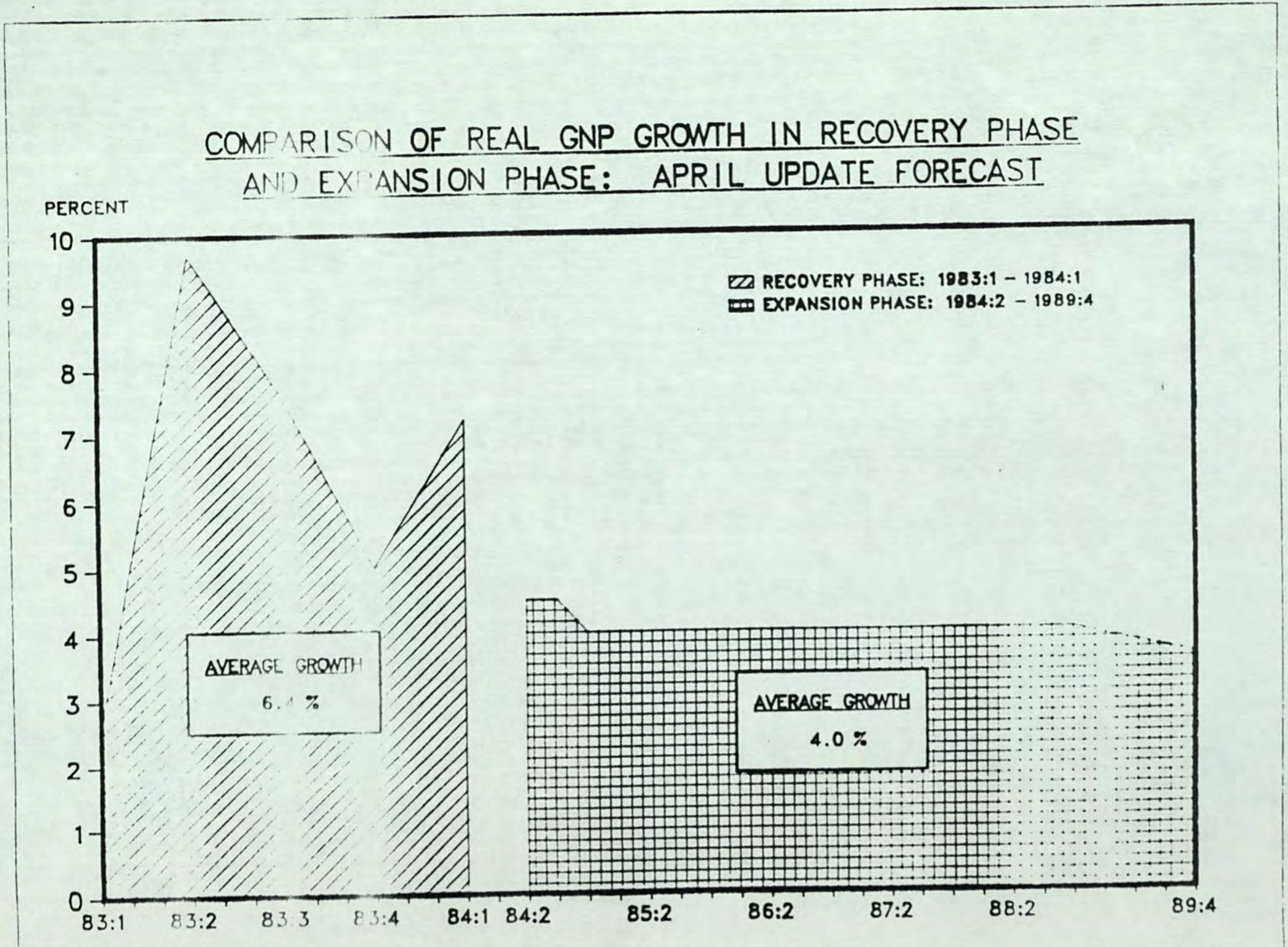


BUDGET SHARES OF GNP
% OF GNP
26
24
22
20
18
16
ACTUAL
PRESIDENT'S FY1985 BUDGET
OUTLAYS
OUTLAYS
DEFICIT
DEFICIT
RECEIPTS
RECEIPTS
81
82
83
84
85
86
87
88
89
* INCLUDES OFF-BUDGET

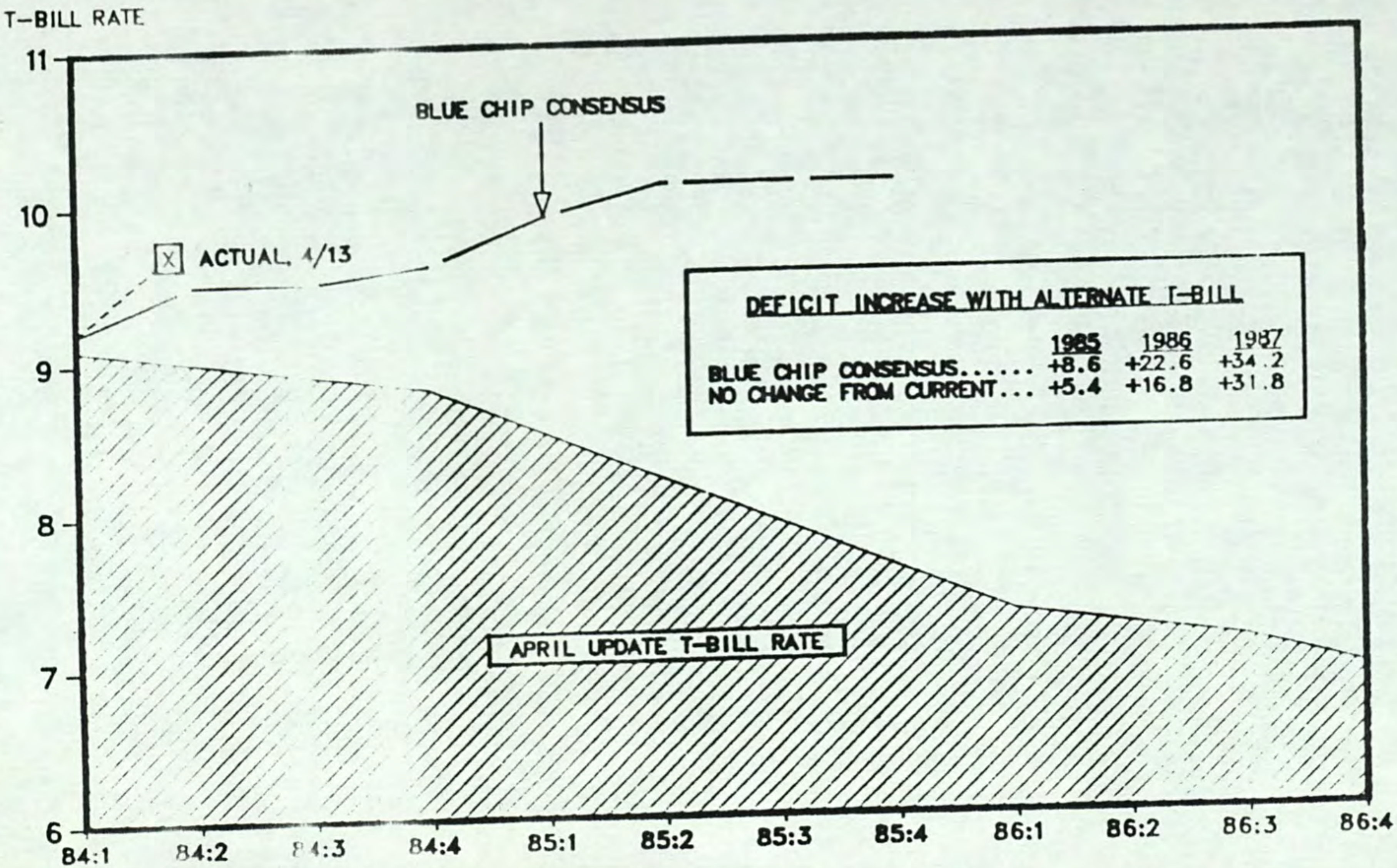
APRIL UPDATE EXPANSION PHASE: LONGER AND STRONGER THAN MOST POST-WAR CYCLES



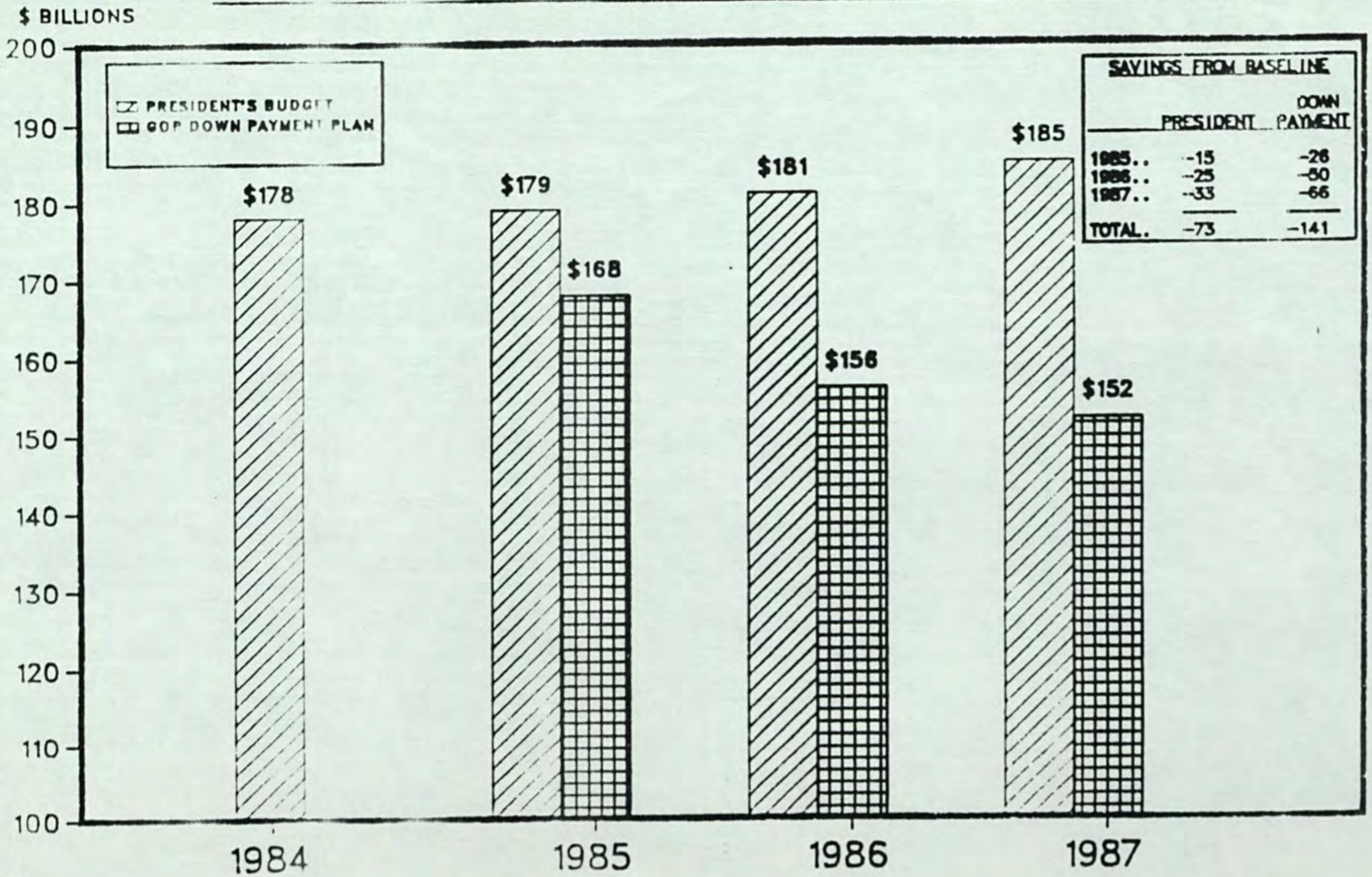

RECOVERY PHASE: APRIL UPDATE REAL GNP GROWTH:
EQUAL TO POST-WAR AVERAGE
PERCENT
10
9
8
7
6
5
4
3
2
1
0
CUMULATIVE REAL GNP GROWTH
+8.1%
+4.1%
APRIL UPDATE - FIRST 5 RECOVERY QUARTERS (1982:4 - 1984:1)
POST-WAR AVERAGE, FIRST 5 RECOVERY QUARTERS
JANUARY 1983 FORECAST
TROUGH
QUARTER 1
QUARTER 2
QUARTER 3
QUARTER 4
QUARTER 5


COMPARISON OF REAL GNP GROWTH IN RECOVERY PHASE
AND EXPANSION PHASE: APRIL UPDATE FORECAST
PERCENT
10
9
8
7
6
5
4
3
2
1
0
RECOVERY PHASE: 1983:1 - 1984:1
EXPANSION PHASE: 1984:2 - 1989:4
AVERAGE GROWTH
6.4 %
AVERAGE GROWTH
4.0 %
83:1
83:2
83:3
83:4
84:1
84:2
85:2
86:2
87:2
88:2
89:4

APRIL UPDATE T-BILL RATE VS. BLUE CHIP FORECAST



APRIL UPDATE DEFICIT OUTLOOK:
PRESIDENT'S BUDGET AND GOP DOWN PAYMENT PLAN



U. S. BUDGET TRENDS

April 18, 1984
Office of Management and Budget

NOTE OF A MEETING BETWEEN THE CHIEF SECRETARY AND DR. BERYL SPRINKEL, UNDER SECRETARY FOR MONETARY AFFAIRS, US TREASURY, AT 11.00 A.M. ON WEDNESDAY, 18 APRIL, 1984

1. The Chief Secretary enquired about progress on the three-year deficit reduction package that was proceeding through the Congress. Dr. Sprinkel said he was confident that it would be passed; the tax side of the package had already cleared the House and Senate and the Conference on the entire package would take place in late May. The total budgetary savings - which fell mainly in the second and third years - amounted to $150 - $180 bn. After the elections, further action to reduce spending would be taken. The deficit for the current fiscal year (FY 84) was running $6-7 bn below estimate, and the economy was slowing down. Both of these factors could reduce interest rates, which were still too high.

2. Dr. Sprinkel said that representatives of foreign countries were continually asking the US to reduce its budget deficit. But a large deficit was (unfortunately) necessary for the time being to frighten Congress and thus bludgeon it into making expenditure cuts. The main problem was that special interest groups had too much power in the Congress. To act as a countervailing influence, the President had proposed that he should be given a veto over "line items" in the budget passed by Congress, as many State Governors had over State budgets. This change in its purest form would require a constitutional amendment, but it would be possible to achieve much the same result by altering the budgetary powers of the President over line items through legislation. Whether such legislation could be passed would depend on the outcome of the Congresssional elections next year. Another proposal of the Administration was for a Constitutional amendment which, with several let-outs to allow for emergencies, would require a balanced budget by law. The support of only two further States was necessary to satisfy the requirements of the Constitution for the calling of a Convention which could pass the amendment. If the amendment were passed in the form advocated by Milton Friedman, the various pressure groups would need to compete with each other for a given amount of resources - which would be a good thing. In the 1960s, the US had a much smaller proportion of its GNP devoted to public expenditure than was typically the case in Europe, but there had been some catching up since then. At the Federal level alone, the proportion was now 19-24% - and this undesirable trend needed to be reversed.

3. The Chief Secretary asked Dr. Sprinkel what he regarded as an acceptable target for the deficit. Dr. Sprinkel said that a Federal deficit equal to 1 or 2 per cent of GNP might be tolerable, but that he was mainly concerned about the spending/GNP ratio rather than the deficit. Returning to a favourite theme, Dr. Sprinkel said that to reduce the deficit by increasing taxes could cause Congress to feel free to spend more - leading to the same deficit at a higher level of spending. The key was therefore to control spending. The Chief Secretary commented that the UK's spending plans were to stabilize spending in real terms over three years and referred to the Secretary of State for Social Services' inquiry into entitlement programmes and to the UK Green Paper on longer-term trends. Dr. Sprinkel said that a three-year freeze in real terms was a worthwhile objective in the short run.

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4. Dr. Sprinkel pointed to the fall in unemployment in the US, which he attributed to a flexible labour market and a low (18-19%) level of unionisation. He acknowledged however that youth unemployment was high in the US (especially among young blacks) and a probable cause of this was he thought Federal minimum wage legislation - this might be amended after the election. The Chief Secretary said that the UK had no minimum wage legislation, except that affecting particular low-paid Wages Council industries.

5. In reply to a question from the Chief Secretary, Dr. Sprinkel said that the talks with the Japanese about liberalising Japanese capital markets had been "about two-thirds successful". There had been major progress in opening up the Japanese market to foreign banks, underwriters, insurers etc. The deregulation of Japanese interest rates seemed likely to be accelerated somewhat, starting with those on large certificates of deposit and proceeding downwards. On Euro-Yen, the Japanese had agreed to allow more (although not unlimited) access to the capital market under the watchful eye of their Finance Ministry. Overall, it had been a useful exercise. The Chief Secretary asked about the possible role of the GATT in freeing capital movements. Dr. Sprinkel said he thought that the GATT would have difficulties in making progress since most countries, including France and Germany, had rigidities in their financial markets. It was possible however that progress could be made in the relevant OECD fora. The Chief Secretary commented that there was not full freedom of capital movements even within the EC, to which Dr. Sprinkel said that it was important for countries such as the UK and US to keep up the pressure for progress.

6. Dr. Sprinkel said that he had two final specific points to make to the Chief Secretary:

1. On export credit, he thought that there was a strong case for keeping countries with debt problems such as Brazil on cover, provided that they were adhering to an IMF programme. He understood that the UK (and Germany) had taken Brazil off medium-term cover. The Chief Secretary pointed out that ECGD had a requirement to balance its own books, but thought that to avoid major inroads being made into a difficult market such as Brazil by only one supplier, it would be necessary for all the major suppliers to co-ordinate their export credit policies towards that market. He undertook to ponder Dr. Spinkel's point.

2. Dr. Sprinkel said that the US Administration agreed with the proposal to phase out credit mixte over three years, and the UK could count on US support within OECD for this proposition. But beyond the three year period, his view was that credit mixte would be acceptable provided that the aid element was at least 50 per cent. The Chief Secretary commented that the Germans, who had a good record on this issue, had taken the lead in the campaign against credit mixte. Dr. Sprinkel commented that the US fund for credit mixte was to be used strictly for defensive purposes, and would be targeted strictly against the worst abuses of others.

H.G. Walsh
British Embassy
20 April, 1984

NOTE OF A MEETING BETWEEN THE CHIEF SECRETARY AND MR. RUDOLPH PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ON 18 APRIL AT 10.00 A.M.

1. The Chief Secretary asked for Mr. Penner's terms of reference in relation to those of the head of the Government Accounting Office (GAO), Mr. Bowsher. Mr. Penner said that the functions of the CBO included forecasting the economy and, in the light of this, predicting the effects of options for changes in public expenditure programmes. These options were compared with a base line cost (estimated on several different assumptions about the economy) that assumed no policy changes were made. The GAO, on the other hand, focussed on micro issues and on value for money. (A small area of overlap of the CBO with the GAO was in the programme evaluation field). The CBO also had links at technical level with the Office of Management and Budget and the Council of Economic Advisers and he regularly conferred with Mr. Stockman and Dr. Feldstein. These links were absolutely essential, since the Executive branch was the main source of information for the CBO. The CBO was non-political and did not make policy recommendations. It merely reviewed the costs of various options for the Congress.

2. Dr. Penner then described the five-year forecast of the Budget prepared by the CBO, the present version of which indicated a deficit of slightly under $200 bn in 1984-85 (assuming the continuation of the recovery). Beyond that, if nothing were done to reduce expenditure or raise taxes, the deficit was expected to rise both absolutely and as a percentage of GNP. An assumption was made that real defense expenditure would rise at an annual rate of 5 per cent. It would be hard to avoid such a steep rise because a lot of the expenditure - e.g. on the B-1 bomber, the MX missile and a large nuclear aircraft carrier - was already contractually committed. This would make the price of cancellation unattractive even if the weapons were no more than marginally effective.

3. The Chief Secretary asked whether US public expenditure was appropriated on an annual basis. Dr. Penner said that this was the case although, particularly in the defense field, exceptions were sometimes made. The Congress apparently preferred year-by-year control of programmes over the achievement of lower costs by multi-year appropriations. In the entitlement field, the rule was that expenditure simply was demand-determined on the basis of qualification criteria. It was not formally appropriated.

4. In reply to a question from the Chief Secretary, Dr. Penner said that the CBO forecast US inflation to be 5% in 1984, and on a downward trend thereafter. Inflation was not the most uncertain factor affecting public expenditure. This was interest rates. A one per cent error in forecasting interest rates during the budget period would have the cumulative result of adding $30 bn to the deficit by 1989. The CBO estimated a budget deficit of 3.1% of GNP by 1989 even on the most favourable assumptions about growth, unemployment, interest and inflation.

5. The Chief Secretary asked which non-defence programme was growing the fastest. Dr. Penner said that, apart from defense and interest payments, health programmes were growing fastest at 12 per cent a year. Education, mainly a State and local level responsibility, was not growing quickly and demographics were favourable to cutting costs although there was pressure to increase the Federal share of these costs. (Dr. Penner noted wryly in passing that Administration attempts

to cut welfare expenditure by focussing on the "truly needy" had disincentive effects not consistent with its supply-side slogans.) Agricultural support programmes were a disaster area, mainly because the high dollar exchange rate, the effects of the CAP and the debt constraints of LDCs made exporting US agricultural products difficult. This was aggravated by Administration policy towards the USSR which meant that the US was not regarded as a reliable supplier. The Congress had just passed a bill, increasing agricultural support levels next year, but freezing them for the three subsequent years - the Congress could in future reverse this legislation however.

6. In response to a question from Mr. Gieve, Dr. Penner said that the Administration was getting a better grip on the credit programmes which constituted the bulk of Federal off-budget expenditure. These expenditures now amounted to $15-20 bn. Offsetting this, the States and localities currently had surpluses on their budgets, as was typical at the peak of the business cycle. It was a subject of debate whether the surpluses in the States' pension funds should also be scored as a credit in the public sector accounts - this depended in his view on the extent to which they were a net addition to private sector savings.

7. Asked by the Chief Secretary about the "downpayment" package, Dr. Penner said that he regarded developments as favourable. The package indicated a new psychological climate in the Congress favourable to reducing deficits. It had widespread bipartisan support, and the main issue to be resolved between House and Senate was the proposed level of defense expenditure. The package was important as a step towards stabilising interest costs on the public debt, which had shown signs of getting out of control. It would only take, following the passage of the present measures, the passage of a package of the same size after the election to prevent interest costs from rising significantly and the debt/GNP ratio would have been stabilised.

H.G. Walsh
British Embassy
Washington D.C.

19 April, 1984