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FM WASHINGTON 112352Z FEB 85

TO PRIORITY F C O

TELEGRAM NUMBER 463 OF 11 FEBRUARY

INFO ROUTINE PARIS, BONN, TOKYO, ROME, UKREP BRUSSELS, UKDEL OECD,  
UKDEL NATO, ALL CGS IN THE U.S.

U S FY86 BUDGET: LATEST DEVELOPMENTS.

REF: OUR TELNOS 360 AND 412.

*Summary only*  
*CDP*  
*12/2*

## SUMMARY

1. JUDGING FROM A HOST OF RECENT PUBLIC STATEMENTS AND CONGRESSIONAL TESTIMONIES, IT SEEMS CLEAR THAT THE PRESIDENT'S FY 86 BUDGET PROPOSALS ARE IN FOR A ROUGH RIDE AND WILL BE SUBSTANTIALLY ALTERED BY THE CONGRESS. TREASURY SECRETARY BAKER HAS NOW SAID THAT HE WOULD RULE OUT TAX INCREASES EVEN AS A LAST RESORT IF NO PROGRESS IS MADE ON THE ADMINISTRATION'S EXPENDITURE REDUCTION PROPOSALS DURING THE BUDGET PROCESS THIS YEAR. MOST COMMENTATORS BELIEVE THAT THE ADMINISTRATION WILL FIND IT DIFFICULT TO ACHIEVE ITS TARGET OF DOLLARS 50 BILLION IN EXPENDITURE SAVINGS IN FY86.

## DETAIL

2. IN HIS 6 FEBRUARY STATE OF THE UNION ADDRESS THE PRESIDENT GAVE THE REFORM AND SIMPLIFICATION OF THE U S TAX SYSTEM A HIGH PRIORITY AND DID NOT ELABORATE MUCH ON HIS BUDGET PROPOSALS BEYOND STRESSING THE NEED FOR A FREEZE ON SPENDING IN FY86 AND FOR CONSTITUTIONAL REFORMS TO GIVE HIM INCREASED BUDGETARY POWERS. PUTTING HIS FAITH IN INCREASED ECONOMIC GROWTH TO REDUCE THE DEFICIT, THE PRESIDENT MENTIONED A TOP RATE OF INCOME TAX OF 35 PERCENT AS THE TARGET OF A BIPARTISAN TAX BILL, WITHOUT ALSO STRESSING THAT THIS COULD ONLY BE ACHIEVED IF THE TAX BASE WERE BROADENED ENOUGH. IN A SUBSEQUENT INTERVIEW WITH THE WALL STREET JOURNAL, HE ALSO SAID THAT HE WOULD HAVE TO BE CONVINCED OF THE NEED TO CHANGE THE ACCELERATED DEPRECIATION PROVISIONS FOR COMPANIES INTRODUCED IN THE 1981 ECONOMIC RECOVERY TAX ACT AND IMPLIED THAT THE ONLY GROUPS WHO SHOULD PAY MORE UNDER TAX REFORM WOULD BE THOSE WHO WERE TAKING CONVOLUTED STEPS TO AVOID IT UNDER THE PRESENT TAX CODE, ALTHOUGH HE ALSO MADE THE SAVING REFERENCE THAT TAX REFORM WOULD BE REVENUE-NEUTRAL. TREASURY SECRETARY BAKER THEN TOLD THE HOUSE APPROPRIATIONS COMMITTEE THAT THE ADMINISTRATION WOULD NOT PROPOSE A TAX INCREASE EVEN IF CONGRESS FAILS TO MAKE PROGRESS IN REDUCING THE BUDGET DEFICIT THIS YEAR.

3. ON EXPENDITURE, THE MOST SIGNIFICANT DEVELOPMENT IS THAT SENATOR DOLE HAS ABANDONED HIS ATTEMPT PERSONALLY TO CO-ORDINATE A DRAFT OF AN ALTERNATIVE SET OF PROPOSALS TO THOSE OF THE ADMINISTRATION AND THAT THE PROPOSALS TO BE PUT TO THE SENATE WILL BE PROCESSED THROUGH THE NORMAL (AND SLOWER) CHANNEL OF

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SENATOR DOMENICI'S BUDGET COMMITTEE. IT SEEMS LIKELY THAT THIS COMMITTEE WILL PROPOSE TO REDUCE THE PRESIDENT'S PROPOSALS FOR THE FULL INDEXATION OF SOCIAL SECURITY AND FOR MUCH HIGHER DEFENCE EXPENDITURE. SENATOR DOLE WISHES (VERY AMBITIOUSLY) TO HAVE A BINDING VOTE ON THE BUDGET SPENDING CUTS AS EARLY AS THE END OF MARCH, AFTER WHICH THE ADMINISTRATION'S TAX REFORM BILL WOULD BE PRESENTED. THIS WOULD USE THE EXPERIENCE IN 1981 AS A PRECEDENT (WHEN THROUGH THE SO-CALLED RECONCILIATION PROCEDURE A BINDING BUDGET FOR FY82 WAS PASSED IN LATE JULY INCORPORATING DOLLARS 35 BN IN EXPENDITURE CUTS). BUT THE DEMOCRATS ACQIESCED TO AN ABBREVIATED PROCEDURE IN 1981, WHEREAS THIS YEAR SPEAKER O'NEILL CLAIMS THAT THEY WILL SCRUTINISE EACH PROPOSED CUT.

4. ON THE AMOUNT OF THE PROPOSED EXPENDITURE CUTS, MOST OUTSIDE COMMENTATORS BELIEVE THAT DOLLARS 50 BN WILL BE A DIFFICULT TARGET TO REACH. EVEN BUDGET DIRECTOR STOCKMAN TOLD THE SENATE BUDGET COMMITTEE THAT THE FY86 ADMINISTRATION BUDGET PROPOSALS "MAY WELL CONSTITUTE THE BULK OF WHAT IS FEASIBLE, WHAT IS PRACTICAL AND JUSTIFIABLE TO DO IN THIS DECADE". WHILE FED CHAIRMAN VOLCKER TOLD THE JOINT ECONOMIC COMMITTEE THAT THERE WOULD BE AN ADVERSE IMPACT ON FINANCIAL MARKETS, LEADING TO HIGHER INTERESTS RATES, IF CONGRESS FAILED TO CUT THE DEFICIT BY AT LEAST DOLLARS 50 BN, C B O DIRECTOR PENNER (HAVING PREDICTED THAT THE DEFICIT COULD RISE TO AS HIGH AS DOLLARS 400 BN BY 1990 IF THERE WERE A RECESSION) SAID THAT DOLLARS 50 BN WAS AMBITIOUS AND THAT A MORE REALISTIC AND RELEVANT OBJECTIVE WOULD BE TO STOP THE AMOUNT OF PUBLIC DEBT GROWING AS A PERCENTAGE OF GNP BEYOND FY88.

5. IN TERMS OF INDIVIDUAL EXPENDITURE AREAS, BUDGET DIRECTOR STOCKMAN HAS ACKNOWLEDGED TO THE CONGRESS THAT IN HIS VIEW DEFENCE SPENDING SHOULD HAVE BEEN CUT FURTHER THAN HAS BEEN PROPOSED BY THE ADMINISTRATION, AND HAS GONE SO FAR AS TO REFER TO THE GROWTH OF MILITARY RETIREMENT BENEFITS AS "A SCANDAL AND OUTRAGE", DRAWING SHARP RESPONSES FROM VETERANS' GROUPS. SENATOR DOLE HAS STATED THAT HE WOULD LIKE TO SEE A 3 PERCENT REAL INCREASE IN DEFENCE SPENDING INSTEAD OF THE 5.9 PERCENT SOUGHT BY THE ADMINISTRATION AND HOUSE MAJORITY LEADER WRIGHT HAS SUGGESTED THAT HE ALSO WOULD BE ABLE TO ACCEPT 3 PERCENT.

6. ON AGRICULTURE, BUDGET DIRECTOR STOCKMAN HAS OFFERED TO THE CONGRESS A COMPACT UNDER WHICH, IF THE CONGRESSMEN FROM FARM STATES ACCEPTED THE ADMINISTRATION'S FARM BILL, THE ADMINISTRATION IN RETURN WOULD PROVIDE SHORT-TERM CREDIT TO FARMERS IN FINANCIAL DIFFICULTIES. THIS OFFER WAS ANGRILY TURNED DOWN BY FARM STATE CONGRESSMEN AND IN THE END HAK

CONGRESSMEN AND IN THE END THE ADMINISTRATION HAD TO MAKE A FIRM OFFER OF A FARM CREDIT PACKAGE WITHOUT RECEIVING ANY ASSURANCES IN RETURN. MOREOVER, THIS PACKAGE MAY HAVE TO BE

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AUGMENTED TO MEET VARIOUS CRITICISMS OF ITS INADEQUACY. THE ADMINISTRATION'S PROPOSALS TO CUT FARM SUBSIDIES ARE CLEARLY IN FOR A ROUGH RIDE AND IT WOULD BE SURPRISING IF THEY WERE NOT SCALED DOWN DURING THE BUDGET PROCESS BECAUSE OF THE STRENGTH OF FEELING IN THE FARM STATES.

### COMMENT

7. TAX INCREASES HAVE APPARENTLY BEEN RULED OUT OF COURT BY THE TREASURY SECRETARY ALTOGETHER FOR THIS YEAR AND THE PRESIDENT HAS COME CLOSE TO ATTACHING HIMSELF TO THE OBJECTIVE OF A 35 PERCENT TOP RATE OF INCOME TAX. THERE IS A LONG WAY TO GO BEFORE EXPENDITURE REDUCTIONS ARE WITHIN SIGHT. THE SUCCESS OF EVEN A MORE MODEST PACKAGE OF SPENDING REDUCTIONS THAN PROPOSED WILL DEPEND ON THE WILLINGNESS OF THE ADMINISTRATION TO COMPROMISE AND AGREE TO CUT DEFENCE EXPENDITURE FURTHER. C B O DIRECTOR PENNER IS PROBABLY RIGHT WHEN HE STATES THAT A REALISTIC TARGET WOULD BE TO STABILISE THE DEBT/GNP RATIO BY FY88, BUT EVEN THIS WILL BE DIFFICULT TO ACHIEVE. AS REAL CUTS BECOME INCREASINGLY HARD TO MAKE, SOME OF THE EXPENDITURE REDUCTIONS THAT EVENTUALLY EMERGE MAY NOT REFLECT TRUE REDUCTIONS IN PUBLIC SECTOR CLAIMS ON THE FINANCIAL MARKETS, E.G. THE PROPOSAL THAT EX-IM BANK SHOULD ABANDON DIRECT LENDING FOR EXPORT CREDIT AND INSTEAD ONLY GUARANTEE PRIVATE SECTOR LOANS FOR EXPORTS.

9. F C O PLEASE ADVANCE TO SHIELDS (TREASURY), GREEN (BANK) AND BROADBENT (ECONOMIC ADVISERS).

WRIGHT

~~ADVANCED AS REQUESTED~~

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