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## U S ECONOMIC PROGRAMME: BUDGETARY LEGISLATION

1. CONGRESS HAVE PASSED AND SENT TO THE PRESIDENT FOR SIGNATURE THE TAX AND BUDGET RECONCILIATION BILLS. (SEE MY TELNO 2303 OF 31 JULY). PRESIDENT REAGAN IS EXPECTED TO SIGN THEM SHORTLY.

2. THE TAX BILL SUBSTANTIALLY ALTERS THE U S FEDERAL TAX STRUCTURE. ITS MAIN FEATURES ARE (A) REDUCTIONS ON 25 PERCENT IN PERSONAL INCOME TAX RATES IN THREE STAGES OVER 33 MONTHS STARTING ON 1 OCTOBER 1981 AND (B) ACCELERATED DEPRECIATION ALLOWANCES FOR U S BUSINESS INVESTMENT BASED MAINLY ON STANDARD DEPRECIATION PERIODS OF 10, 5 OR 3 YEARS FOR DIFFERENT CATEGORIES OF INVESTMENT. THE PERSONAL INCOME TAX CUTS WILL REDUCE THE TOP MARGINAL RATE TO JUST OVER 50 PERCENT, AND THE MAXIMUM TAX ON LONG TERM CAPITAL GAINS TO JUST OVER 20 PERCENT. THE BILL ALSO INCLUDES A LARGE NUMBER OF SMALLER MEASURES THAT WERE ADDED DURING CONGRESSIONAL CONSIDERATION TO ATTRACT SUPPORT FROM DEMOCRATS. THESE INCLUDE TAX RELIEF FOR OIL PRODUCERS; DIRECT TAX INCENTIVES FOR SAVING; REDUCTIONS IN GIFT AND ESTATE TAXES; AND INDEXATION OF ALL PERSONAL INCOME TAX BRACKETS FROM FY85 ONWARDS.

3. THE NET EFFECT OF THE TAX CHANGES WILL BE TO REDUCE REVENUES, COMPARED WITH PREVIOUS PROJECTIONS, BY US DOLLARS 37.7BN IN FY82, RISING TO US DOLLARS 149.9BN IN FY84. OF THE TOTAL CUTS IN FY82, THE PERSONAL TAX CHANGES ACCOUNT FOR SOME US DOLLARS 26.9NB, BUSINESS TAX CHANGES US DOLLARS 10.7NB, ENERGY-RELATED PROVISIONS US DOLLARS 1.3BN, AND SAVINGS INCENTIVES US DOLLARS 0.3BN. ELIMINATION OF MOST COMMODITY TAX STRADDLES INCREASE REVENUE BY SOME US DOLLARS 0.6BN. ON THE ADMINISTRATION'S ECONOMIC ASSUMPTIONS, FEDERAL REVENUES ARE NOW FORECAST TO DECLINE FROM 21.1 PERCENT OF G N P IN 1981 TO 19.0 PERCENT IN FY84.

4. THE BUDGET RECONCILIATION BILL REDUCES THE SCOPE OF A NUMBER OF FEDERAL EXPENDITURE PROGRAMMES AND WILL PROVIDE EXPENDITURE SAVINGS OF SOME US DOLLARS 35BN IN FY82 RISING TO US DOLLARS 55.6BN IN FY-84. IT AFFECTS A NUMBER OF SENSITIVE AREAS OF FEDERAL EXPENDITURE, INCLUDING FOR EXAMPLE THE REPEAL OF THE MINIMUM SOCIAL SECURITY BENEFIT FOR BOTH NEW AND EXISTING BENEFICIARIES, AND CUTS IN THE PUBLIC SERVICE EMPLOYMENT PROGRAMME, IN THE FOOD STAMP PROGRAMME AND IN TRADE ADJUSTMENT ASSISTANCE FOR THE UNEMPLOYED. THE BROAD PROVISIONS OF THE BILL WILL NOW NEED TO BE TRANSLATED, AFTER THE SUMMER RECESS, INTO DETAILED APPROPRIATIONS FOR EACH SERVICE FOR FY82.

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5. THE PASSAGE OF THE TAX AND BUDGET RECONCILIATION BILLS REPRESENTS A VERY SIGNIFICANT POLITICAL ACHIEVEMENT FOR PRESIDENT REAGAN, AND GIVES HIM MOST OF THE ECONOMIC MEASURES WHICH HE SOUGHT FOR FY82. THERE ARE, HOWEVER, SOME SIGNIFICANT DIFFERENCES FROM THE PROGRAMME WHICH HE ORIGINALLY PRESENTED. ON THE TAX SIDE, THE 30 PERCENT CUT WHICH HE ORIGINALLY PROPOSED IN PERSONAL TAX RATES, IN 3 EQUAL INSTALMENTS OVER 3 YEARS, HAS NOW BEEN SCALED BACK TO 25 PERCENT, WITH THE FIRST INSTALMENT REDUCED TO 5 PERCENT AND DEFERRED TO 1 OCTOBER 1981. THE BUSINESS TAX MEASURES WENT THROUGH BROADLY AS PROPOSED. THE LARGE NUMBER OF EXTRA TAX MEASURES CONCEDED TO GAIN CONGRESSIONAL SUPPORT ARE NOT FULLY CONSISTENT WITH THE STATEMENT IN HIS INAUGURAL ADDRESS QUOTED IN MY DESPATCH OF 16 APRIL, THAT THE TAX SYSTEM QUOTE MUST NOT BE USED TO REGULATE THE ECONOMY NOR BRING ABOUT SOCIAL CHANGE UNQUOTE. ON THE EXPENDITURE SIDE, HE HAS GOT THE BULK OF THE SAVINGS WHICH HE SOUGHT, BUT THE CONGRESS DID NOT FULLY IMPLEMENT HIS PROPOSALS TO COMBINE NUMEROUS SPECIFIC GRANTS TO THE STATES AND CITIES INTO BROADER BLOCK GRANTS. THE REJECTION BY CONGRESS OF HIS FIRST PROPOSALS TO REFORM THE SOCIAL SECURITY SYSTEM ALSO DOES NOT AUGUR WELL FOR OBTAINING THE FURTHER SPECIFIC SPENDING CUTS WHICH ARE STILL REQUIRED FOR YEARS AFTER FY82.

6. IN THE LONGER TERM, A NUMBER OF QUESTION MARKS REMAIN OVER THE SUCCESSFUL IMPLEMENTATION OF THE ECONOMIC RECOVERY PROGRAMME. THESE INCLUDE:

A. THE EXPENDITURE SAVINGS INCLUDED IN THE RECONCILIATION BILL ONLY ACHIEVE ABOUT HALF OF THE SAVINGS WHICH THE ADMINISTRATION CALCULATE TO BE REQUIRED TO BALANCE THE FEDERAL BUDGET BY FY84. SAVINGS OF AT LEAST US DOLLARS 33BN IN FY83 AND US DOLLARS 44BN IN FY84 REMAIN TO BE FOUND. THE ADMINISTRATION WILL THUS NEED TO IDENTIFY OVER THE NEXT SIX MONTHS SUBSTANTIAL FURTHER SAVINGS THAT ARE ACCEPTABLE TO CONGRESS (AND ADDITIONAL TO ITS PLANNED SOCIAL SECURITY REFORM) IF ITS TARGETS ARE TO BE MET.

B. FROM THE START, EXPERTS FROM ALL POINTS ON THE POLITICAL SPECTRUM HAVE QUESTIONED WHETHER THE CLAIMED EFFECTS OF THE PERSONAL INCOME TAX CUTS ON SAVINGS AND WORK INCENTIVES WILL MATERIALISE. THE PRUNING OF THE TOTAL CUT FROM 30 TO 25 PERCENT MEANS THAT IT NOW DOES LITTLE MORE THAN OFFSET INFLATIONARY QUOTE BRACKET CREEP UNQUOTE AND HIGHER SOCIAL SECURITY TAXES. THE U S ADMINISTRATION CONTINUE TO ARGUE IN REPLY THAT THE BENEFIT WILL BE FELT BECAUSE PEOPLE WILL HAVE THE ASSURANCE THAT THE TAX BURDEN WILL NOT FURTHER INCREASE, AND BECAUSE MARGINAL TAX RATES FOR HIGHER INCOME EARNERS ARE BEING REDUCED. THEY HAVE, HOWEVER, ADVANCED LITTLE EMPIRICAL EVIDENCE FOR THIS VIEW.

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C. MANY OBSERVERS, INCLUDING THE O E C D AND I M F, HAVE QUESTIONED WHETHER THE ADMINISTRATION WILL BE ABLE TO GET THE SIMULTANEOUS QUICK RETURN TO RAPID ECONOMIC GROWTH AND LOW INFLATION ASSUMED IN ITS ECONOMIC PROJECTIONS. IF THE ECONOMY FAILS TO MATCH UP TO THESE ASSUMPTIONS, THE FISCAL DEFICIT WILL TEND TO BE WIDENED, AND AS THE TAX REDUCTIONS ARE NOW IN PLACE, FURTHER SPENDING CUTS BEYOND THOSE MENTIONED IN (A) ABOVE WOULD BE REQUIRED TO BALANCE THE BUDGET BY FY84. THIS COULD IMPERIL THE PROPOSED RAPID BUILD-UP IN DEFENCE SPENDING.

M D. IN PARTICULAR, DOUBTS HAVE BEEN EXPRESSED WHETHER THE POLICY ENDORSED BY THE ADMINISTRATION CAN BE CONSISTENT WITH ITS ASSUMPTION OF STRONG ECONOMIC GROWTH NEXT YEAR. THE MID-SESSION BUDGET REVIEW USES ECONOMIC ASSUMPTIONS THAT IMPLY SUSTAINED RAPID INCREASES IN MONEY VELOCITY, IN EXCESS OF HISTORICAL EXPERIENCE, AT A TIME WHEN INTEREST RATES ARE PROJECTED TO DECLINE. THE FEDERAL RESERVE BOARD ALSO BELIEVE THAT THE TAX CUTS WILL PLACE AN ADDITIONAL BURDEN ON MONETARY POLICY, AND MAINTAIN AN UPWARD PRESSURE ON INTEREST RATES. IF INTEREST RATES DO REMAIN HIGH, THIS COULD HAVE AN ADVERSE IMPACT ON THE THRIFT INSTITUTIONS AND HEIGHTEN EUROPEAN CONCERN ABOUT THE EFFECTS OF HIGH INTEREST RATES ON THEIR ECONOMIES, AS WELL AS HELPING TO SUSTAIN THE VALUE OF THE DOLLAR. A FURTHER YEAR OF SLUGGISH GROWTH IN 1982 WOULD ALSO MEAN THAT UNEMPLOYMENT WOULD REMAIN HIGH IN THE RUN UP TO THE NEXT CONGRESSIONAL ELECTIONS IN THAT YEAR.

7. F C O PLEASE PASS TO BOTTRILL (TREASURY), HAYWARD BANK OF ENGLAND) AND BROADBENT (F C O).

HENDERSON.

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