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TO IMMEDIATE FCO
TELEGRAM NUMBER 2750 OF 17 SEPTEMBER

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Summary only

U S ECONOMY: PROSPECTS FOR DEFICIT REDUCTION AND TAX REFORM

SUMMARY

1. DURING HIS VISIT ON 13-14 SEPTEMBER, THE FINANCIAL SECRETARY SPOKE TO REPRESENTATIVES OF THE ADMINISTRATION AND THE CONGRESS INVOLVED IN THE BUDGET PROCESS AND WITH PROPOSALS FOR TAX REFORM. THE CONSENSUS VIEW WAS THAT THE EXPENDITURE COMPONENT OF THE FY85 QUOTE DOWNPAYMENT PACKAGE UNQUOTE OF DEFICIT REDUCTIONS WOULD BE ENACTED, BUT THAT FURTHER DEFICIT REDUCTION NEXT YEAR WOULD BE VERY DIFFICULT TO ACHIEVE. THE ADMINISTRATION WOULD FOCUS ON EXPENDITURE REDUCTIONS IN ITS FY86 BUDGET, BUT THE DEMOCRATS IN CONGRESS WOULD INSIST ON AT LEAST SOME TAX INCREASES IF FURTHER BUDGET SAVINGS WERE TO BE AGREED. IMPOSING TAX INCREASES BY CLOSING LOOPHOLES WOULD BE DIFFICULT TO ACHIEVE SINCE MANY HAD ALREADY BEEN CLOSED BY LEGISLATION IN 1982 AND 1984, WHILE THE PRESIDENT WAS IMPLACABLY OPPOSED TO INCREASES IN TAX RATES. ONE WAY OUT OF THE IMPASSE WAS A DEAL UNDER WHICH SOCIAL SECURITY BENEFITS AND INCOME TAXATION WOULD BOTH BE PARTIALLY DE-INDEXED. CHANGES IN THE POLITICAL COMPOSITION OF THE CONGRESS WOULD BE AN IMPORTANT FACTOR AFFECTING DEFICIT REDUCTION PROSPECTS.

2. THE PROSPECTS FOR FUNDAMENTAL TAX REFORM NEXT YEAR WERE JUDGED TO BE HIGHLY PROBLEMATIC SINCE THERE WAS NEITHER ENOUGH LEEWAY IN THE BUDGET TO COMPENSATE LOSERS FROM THE REFORM NOR ENOUGH SUPPORT IN THE ADMINISTRATION FOR RAISING TAXES SUBSTANTIALLY AND THUS NECESSITATE REFORM TO AVOID AN EXCESSIVE RISE IN TAX RATES. IN THE CONGRESS THERE WAS TWO ALTERNATIVE TAX REFORM BILLS IN CONTENTION FOR PASSAGE: BOTH WOULD INTRODUCE MODIFIED VERSIONS OF A FLAT TAX. THE U S TREASURY CONTINUES TO BE INTERESTED IN A VALUE-ADDED TAX (SEE PARAGRAPH 8).

DETAILS

3. ON 13-14 SEPTEMBER, THE FINANCIAL SECRETARY PAID CALLS ON MCNAMAR, PEARLMAN AND MCLURE (US TREASURY), NISKANEN (COUNCIL OF ECONOMIC ADVISERS), CONGRESSMAN JACK KEMP, PENNER (CONGRESSIONAL BUDGET OFFICE) AND SALMON (CHIEF COUNSEL, WAYS AND MEANS COMMITTEE) TO DISCUSS THE PROSPECTS FOR DEFICIT REDUCTION AND TAX REFORM IN THE UNITED STATES. HE ALSO SPOKE TO REPRESENTATIVES OF THE OFFICE OF MANAGEMENT AND BUDGET, THE FEDERAL RESERVE BOARD, THE JOINT COMMITTEE ON TAXATION AND THE SENATE FINANCE COMMITTEE.

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DEFICIT REDUCTION

4. SINCE THE FY85 BUDGET PROCESS REMAINS INCOMPLETE, THE IMMEDIATE ACTION ON DEFICIT REDUCTION IS IN THE CONGRESS ON THE DOLLARS 142 BILLION "DOWNPAYMENT PACKAGE" OF SAVINGS DURING FY85-87, ONLY DOLLARS 63 BILLION OF WHICH (MAINLY TAX INCREASES) WAS CONTRIBUTED BY THE 1984 DEFICIT REDUCTION ACT THAT HAS BEEN SIGNED INTO LAW. THE REMAINING SAVINGS ON DISCRETIONARY PROGRAMMES WILL HAVE TO BE FOUND DURING THE CURRENT APPROPRIATION PROCESS. THE KEY TO THE SUCCESSFUL PASSAGE OF THE SAVINGS IS A COMPROMISE ON DEFENCE EXPENDITURE WHICH NOW APPEARS TO BE ON THE POINT OF BEING AGREED.

5. FURTHER REDUCTIONS IN THE BUDGET DEFICIT WILL PROBABLY HAVE TO AWAIT THE FY86 BUDGET PROCESS, BEGINNING WITH THE FY86 BUDGET SUBMITTED TO THE CONGRESS BY THE PRESIDENT IN JANUARY OR EARLY FEBRUARY. NISKANAN TOLD THE FINANCIAL SECRETARY THAT THE PRESIDENT'S BUDGET WILL NOT CONTAIN ANY PROPOSALS FOR SIGNIFICANT TAX INCREASES BUT WILL PROPOSE ONE "LAST PUSH" TO REDUCE THE DEFICIT BY EXPENDITURE REDUCTIONS - PROBABLY DOLLARS 100 BILLION OF THEM OVER TWO YEARS. IN REJECTING THE IDEA OF TAX INCREASES, HE SAID THAT "WE NOW LIVE IN A HIGH REAL INTEREST RATE AND HIGH DOLLAR WORLD, AND I WOULD NOT RECOMMEND ANYTHING TO THE PRESIDENT THAT WOULD CHANGE THAT".

6. PENNER SAID THAT THE OUTLOOK FOR DEFICIT REDUCTION WOULD BE VERY DIFFICULT NEXT YEAR EVEN IF A CONGRESS WAS RETURNED WITH BROADLY THE SAME POLITICAL COMPOSITION AS NOW. IT WAS POSSIBLE THAT THE SENATE COULD CONTAIN MORE REPUBLICANS OR RIGHT-WING DEMOCRATS FOLLOWING A REAGAN LANDSLIDE, BUT IT WAS MORE LIKELY THAT THERE WOULD BE ONE OR TWO EXTRA LOYAL DEMOCRATS. WHEN ADDED TO THE FIVE OR SO REPUBLICANS WHO NORMALLY VOTE WITH THE DEMOCRATS ON ECONOMIC MATTERS, THIS COULD REDUCE OR ELIMINATE THE EFFECTIVE CONTROL OF THE REPUBLICANS OVER THE UPPER CHAMBER. IF ATTEMPTS TO REDUCE EXPENDITURE FAILED AND THE PRESIDENT WERE WILLING TO TOLERATE TAX INCREASES AS A LAST RESORT, IT WAS ESSENTIAL THAT THE CHAIRMAN OF THE SENATE FINANCE COMMITTEE SHOULD BE SYMPATHETIC. THE PRESENT CHAIRMAN (DOLE) WOULD COOPERATE, BUT IF DOLE WERE TO REPLACE BAKER AS SENATE MAJORITY LEADER SENATOR PACKWOOD WOULD REPLACE HIM AS CHAIRMAN OF THE COMMITTEE AND PACKWOOD FAVOURED MORE TAX LOOPHOLES RATHER THAN FEWER.

7. BALLENTINE (OMB) AND SALMON (A REPUBLICAN AND A DEMOCRAT RESPECTIVELY) ENVISAGED A SCENARIO UNDER WHICH THE PRESIDENT'S PROPOSALS FOR EXPENDITURE REDUCTIONS WOULD BE REJECTED BY THE HOUSE OF REPRESENTATIVES. IN THIS CASE, THEY THOUGHT THERE MIGHT BE A DEAL NEGOTIATED UNDER WHICH THE DEMOCRATS AGREED TO SOME DE-INDEXING OF SOCIAL SECURITY BENEFITS WHILE THE REPUBLICANS AGREED TO SOME DE-INDEXING OF INCOME TAX. SALMON BELIEVED THAT THAT ISSUE MIGHT BE FORCED BY THE DEMOCRATS WHO, IN RESPONSE TO

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THE PRESIDENT'S PROPOSAL FOR A BALANCED-BUDGET AMENDMENT TO THE CONSTITUTION, COULD COMPEL THE ADMINISTRATION TO COOPERATE IN ACTUAL DEFICIT REDUCTION BY REFUSING TO AGREE NEXT YEAR ON AN INCREASE IN THE FEDERAL DEBT LIMIT. (PENNER POINTED OUT HOWEVER THAT A DE-INDEXING SOLUTION MIGHT BE DEEMED TO BREACH THE PRESIDENT'S COMMITMENT NOT TO INCREASE TAX RATES NEXT YEAR).

TAX REFORM

8. PEARLMAN AND MCLURE CONFIRMED THAT THE TREASURY'S RECOMMENDATIONS FOR TAX REFORM, INCLUDING A STUDY OF A FLAT TAX, A TAX ON CONSUMPTION

A NATIONAL SALES TAX AND A VALUE-ADDED TAX (VAT), WILL BE SUBMITTED TO THE PRESIDENT ON SCHEDULE ON 1 DECEMBER. IT HAD NOT BEEN DECIDED WHEN OR IF THEY WOULD BE PUBLISHED. WHILE TREASURY OFFICIALS WERE UNWILLING TO DIVULGE THEIR RECOMMENDATIONS, THEY EXHIBITED A FAIRLY STRONG INTEREST IN A VAT AND, AFTER THE FINANCIAL SECRETARY HAD EXTOLLED THE MERITS OF A VAT TO MCNAMAR, MCLURE COMMENTED THAT IT WOULD BE USEFUL IF THE CHANCELLOR WERE TO DO THE SAME TO SECRETARY REGAN DURING THE IMF/IBRD MEETINGS.

COMMENT

9. IT SEEMED AS IF U S TREASURY INTEREST IN VAT STEMS FROM THE WISH TO ACHIEVE A LOW RATE WITH A FLAT INCOME TAX WHILE RETAINING CERTAIN LOOPHOLES INCLUDING THOSE TO ENCOURAGE SAVING. VAT WOULD BE USED AS A SUPPLEMENTARY TAX TO MAINTAIN BUOYANCY IN THE REVENUE. WHILE A NORMAL VAT WOULD DRAW OBJECTIONS FROM THE INDIVIDUAL STATES AS POACHING ON THEIR INDIRECT TAX BASE, THE LEADING TAX LOBBYIST IN WASHINGTON (CHARLS E WALKER) HAS PROPOSED A VAT THAT APPLIES TO THE WHOLE-SALE STATES OF PRODUCTION ONLY, AND NOT THE RETAIL STAGE. THIS WOULD LEAVE THE STATES A CLEAR FIELD FOR IMPOSING SALES TAXES.

10. CONGRESSIONAL STAFFERS TOLD THE FINANCIAL SECRETARY THAT TAX REFORM PROPOSALS HAVE NOW FOCUSED ON TWO BILLS: KEMP-KASTEN (REPUBLICAN) AND BRADLEY-GEHARDT (DEMOCRAT). BOTH INVOLVE VERSIONS OF A FLAT INCOME TAX (ALTHOUGH BRADLEY-GEHARDT ENVISAGES TWO HIGHER TAX RATES FOR THE TOP 20 PERCENT OF INCOMES). THE MAIN OBSTACLE TO THEIR ENACTMENT IS THE AMOUNT OF BASE-BROADENING THAT WOULD BE REQUIRED AND THE STRONG OPPOSITION OF THE SPECIAL INTEREST GROUPS WHO WOULD BE DIVESTED OF LONG-STANDING TAX BENEFITS. PEARMAN CONFIRMED TO THE FINANCIAL SECRETARY THAT EVEN SLIGHT MODIFICATION OF RELIEF ON MORTGAGE INTEREST FOR UPPER INCOME GROUPS WOULD BE VIRTUALLY IMPOSSIBLE. NISKANEN SAID THAT AS PART OF ANY TAX REFORM THE ADMINISTRATION WOULD WISH TO RETAIN TAX INCENTIVES FOR SAVING, SO THAT A MOVE COULD BE MADE TOWARDS USING CONSUMPTION AS THE TAX BASE RATHER THAN INCOME. IN THE CONGRESS, TAX REFORM PROPOSALS ARE NOT CLEARLY SEPARATED FROM PROPOSALS FOR TAX INCREASES, AND THERE IS AN AWARENESS THAT EITHER OF THE CONTENDING REFORM PROPOSALS COULD EASILY BE MODIFIED SO AS TO GENERATE EXTRA REVENUE.

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11. NONE OF THE FINANCIAL SECRETARY'S INTERLOCUTORS THOUGHT THAT THERE WOULD BE A MAJOR TAX REFORM IN 1985. THIS WAS BECAUSE MOST OF THEM THOUGHT THAT A PRECONDITION FOR TAX REFORM WAS EITHER THAT THERE HAD TO BE SCOPE FOR COMPENSATING LOSERS IN THE REFORM (I.E. A STRUCTURAL BUDGET SURPLUS) OR THE ADMINISTRATION HAD TO WANT TO GENERATE EXTRA TAX REVENUE AND NEEDED REFORM TO DO THIS WITH A MINIMUM EFFECT ON TAX RATES AND INCENTIVES. THERE WAS NO SCOPE FOR THE FORMER AND THE ADMINISTRATION WOULD WISH TO FOCUS ON EXPENDITURE REDUCTIONS NEXT YEAR RATHER THAN TAX INCREASES. BUT THE ADMINISTRATION WAS NONETHELESS EXPECTED TO TRY TO INFLUENCE THE FY86 BUDGET PROCESS IN A WAY THAT WAS CONSISTENT WITH THE BROAD THRUST OF REFORM: SIMPLICATION, BASE-BROADENING, MAINTAINING INCENTIVES FOR SAVING, AND KEEPING MARGINAL INCOME TAX RATES AS LOW AS POSSIBLE.

12. FCO PLEASE ADVANCE TO PS/CHANCELLOR OF THE EXCHEQUER, PS/FINANCIAL SECRETARY, MONGER AND BOTTRILL (TREASURY), AND TAYLOR THOMPSON (INLAND REVENUE).

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