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US BUDGET DEFICIT: LATEST DEVELOPMENTS

SUMMARY

1. THE PRESIDENT'S BUDGET, DUE TO BE PRESENTED TO CONGRESS IN EARLY FEBRUARY, WILL CONTAIN PROPOSALS SUFFICIENT TO RESTRICT OVERALL NOMINAL PUBLIC EXPENDITURE IN FY 86 TO FY 85 LEVELS BUT WILL NOT INCLUDE BUDGET DIRECTOR STOCKMAN'S OBJECTIVE OF REDUCING THE DEFICIT TO DOLLARS 100 BN (2 PER CENT OF GNP) BY FY 88. THE ADMINISTRATION IS CONCERNED MAINLY ABOUT THE STRENGTH OF THE RECOVERY BUT THE DEFICIT IS THE TOP ITEM ON THE CONGRESSIONAL AGENDA. SENIOR REPUBLICAN SENATORS NOW SAY THAT THEY WILL PRODUCE THEIR OWN SERIES OF DEEP-CUTTING BUDGET OPTIONS, PROBABLY EXTENDING TO DEFENCE AND SOME DE-INDEXATION OF SOCIAL SECURITY. THE DEMOCRATS HAVE NOT YET DECLARED THEIR HAND AS THE ANNUAL BUDGET STRUGGLE IS ABOUT TO GET UNDER WAY.

DETAIL

2. THE ADMINISTRATION, HAVING EXTENSIVELY LEAKED THEIR BUDGET PROPOSALS, FACE THE PROSPECT OF PRESENTING A BUDGET DEAD ON ARRIVAL IN CONGRESS. THE REPUBLICANS IN THE SENATE HAVE NOW MADE A BID FOR THE LEAD ON THE BUDGET DEFICIT PROBLEM. DOLE (MAJORITY LEADER) AND DOMENICI (BUDGET COMMITTEE CHAIRMAN) HAVE INTRODUCED A MARKER BILL CALLING FOR THE DEFICIT TO BE REDUCED TO DOLLARS 100 BN (2 PER CENT OF GNP) BY FY 88, BUT INTEND TO ACHIEVE SAVINGS BY THEIR OWN MEANS. THEY HAVE SAID THAT THEY WILL ANNOUNCE THEIR OWN DETAILED PROPOSALS BEFORE THE PRESIDENT'S ARE AVAILABLE. THE DEMOCRATS ALSO CLEARLY REGARD THE DEFICIT AS THE TOP DOMESTIC ISSUE; SPEAKER O'NEILL HAS SAID THAT IT IS THE TOP PRIORITY ITEM ON HIS AGENDA. THE NEW DEMOCRAT CHAIRMAN OF THE HOUSE BUDGET COMMITTEE (GRAY - PENNSYLVANIA) HAS IMPLIED THAT HE WOULD NOT RULE OUT A CUT IN SOCIAL SECURITY IN CERTAIN CIRCUMSTANCES.

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3. AS DISCUSSED WITH THE SENATE REPUBLICAN LEADERSHIP (DOLE, DEMENICI AND MAJORITY WHIP SIMPSON OF WYOMING), THE PROPOSALS ORIGINALLY ENVISAGED BY THE ADMINISTRATION WERE TOO NARROWLY BASED. THEY INCLUDED A FREEZE ON ALL COST-OF-LIVING ADJUSTMENTS IN ENTITLEMENT PROGRAMMES EXCEPT SOCIAL SECURITY AND A FREEZE ON DISCRETIONARY CIVILIAN PROGRAMMES. BUT THEY ALSO INCLUDED A LONG LIST OF MORE SEVERE CUTS OR QUOTE MAJOR PROGRAMME REFORMS UNQUOTE INCLUDING A 5 PER CENT CIVIL SERVICE PAY CUT AND CONTROVERSIAL CUTS IN CHILD NUTRITION ETC. A NUMBER OF PROGRAMMES (E.G. THE JOB CORPS, THE SMALL BUSINESS ADMINISTRATION AND DIRECT LENDING BY THE EXIM BANK) WERE SCHEDULED FOR OUTRIGHT TERMINATION. MANY REPUBLICANS FELT THAT, BECAUSE HE HAD EXCLUDED SOCIAL SECURITY AND DEFENCE SPENDING FROM THE SCOPE OF HIS CUTS, SOME OF BUDGET DIRECTOR STOCKMAN'S PROPOSALS WERE MORE DRACONIAN THAN THEY NEEDED TO BE, WITH LITTLE CHANCE OF BEING ENACTED INTO LAW.

4. REPUBLICAN SENATORS REQUESTED STOCKMAN TO PREPARE FIGURES FOR A COMPREHENSIVE FREEZE ON ALL SPENDING INCLUDING DEFENCE AND SOCIAL SECURITY, SO THAT THERE WOULD BE APPROXIMATE EQUALITY OF MISERY. THEY HAVE SINCE DEVELOPED A MENU OF OPTIONS WHICH WOULD, IN THE UNLIKELY EVENT OF BEING ADOPTED WHOLESALE, REDUCE THE DEFICIT TO DOLLARS 78 BILLION BY FY 89. THE OUTCOME OF THESE EXERCISES, COMPARED WITH THE ADMINISTRATION'S PROPOSALS, IS SHOWN IN THE TABLE BELOW.

	FY 86	FY 87	FY 88
DOLLARS BILLION (INCLUDING ITEMS FORMERLY OFF-BUDGET)			
DEFICIT (NO ACTION)	225	240	235
DEFICIT TARGET	168	136	98
DEFICIT (ADMIN PROPOSALS)	178	167	139
DEFICIT (COMPREHENSIVE FREEZE)	186	171	140
DEFICIT (SENATE OPTIONS TOTAL)	156	126	78

REDUCTIONS IN DEFENCE BUDGET

DEFENCE SAVINGS (ADMIN PROPOSALS)	8.7	9	10
DEFENCE SAVINGS (COMPREHENSIVE FREEZE)	20	35	51

THE IMPLICATIONS FOR THE DEFENCE BUDGET OF A FREEZE ON DEFENCE ARE CLEARLY SUBSTANTIAL, AND SECRETARY WEINBERGER AT LEAST WOULD NOT WISH TO GIVE UP ANY BARGAINING CHIPS THAT COULD BE USED DURING THE ARMS CONTROL NEGOTIATIONS. SENATE DEFENCE APPROPRIATIONS CHAIRMAN STEVENS AND SENATOR GOLDWATER HAVE ALSO RAISED OBJECTIONS. MEETINGS ARE STILL BEING HELD DURING WHICH ONE OF THE ADMINISTRATION'S OBJECTIVES IS TO DRAW THE REPUBLICAN SENATE BUDGET LEADERSHIP ACROSS MORE TO THE PRESIDENT'S PROPOSALS.

5. THE PRESIDENT'S PERSONAL STAND ON THE BUDGET IS THAT HE WELCOMES THE EFFORTS OF REPUBLICAN CONGRESSMEN TO DRAFT THEIR OWN PROPOSALS. DESPITE ELECTION PROMISES, HE HAS EXPRESSED A WILLINGNESS EVEN TO CONSIDER PROPOSALS TO FREEZE THE INDEXATION OF SOCIAL SECURITY PAYMENTS PROVIDED THAT THEY ARE AGREED FIRST IN THE CONGRESS ON A BI-PARTISAN BASIS. HE REMAINS ADAMANTLY OPPOSED TO PROPOSALS FOR TAX INCREASES BECAUSE OF THEIR POSSIBLE EFFECT ON THE RECOVERY, BUT THE FACT THAT HIS OWN PROPOSALS WILL ALMOST CERTAINLY FALL SHORT OF THE FY 88 TARGET OF A DOLLARS 100 BN DEFICIT COULD INVITE SUCH PROPOSALS FROM ELSEWHERE. ON TAX REFORM, HE HAS NOW SAID THAT HE INTENDS TO PURSUE TAX SIMPLIFICATION THIS YEAR ON A SEPARATE TRACK FROM THE BUDGET. HE WILL HAVE REGAN IN THE WHITE HOUSE TO HELP HIM WITH THE NECESSARY CONSULTATIONS WITH CONGRESS AND INDUSTRY LOBBYISTS.

6. THE AMENDMENTS TO THE PROPOSALS ON TAX REFORM THAT ARE NOW BEING DISCUSSED ARE CONCESSIONS IN THE FIELDS OF THE ACCELERATED COST RECOVERY SYSTEM (DEPRECIATION ALLOWANCES) SEMICLN INDEXATION OF INTEREST SEMICLN TREATING CAPITAL GAINS AS INCOME SEMICLN AND CHARITABLE CONTRIBUTIONS. MIXED VIEWS ARE ALSO EMERGING AS TO WHETHER THE PERSONAL EXEMPTION SHOULD, AS PROPOSED, BE DOUBLED FROM DOLLARS 1,000 TO DOLLARS 2,000. BUT SO FAR TREASURY OFFICIALS RESPONSIBLE FOR TAX POLICY HAVE INDICATED THAT THEY WISH THE TAX REFORM PACKAGE TO HOLD TOGETHER AS LONG AS POSSIBLE. THE CHIEF DANGER OF MAKING COSTLY CONCESSIONS ON DEPRECIATION ALLOWANCES WOULD BE TO DESTROY THE BALANCE OF A PACKAGE WHICH, ALTHOUGH REVENUE NEUTRAL OVERALL, FAVOURS HOUSEHOLDS AND REQUIRES COMPANIES TO CONTRIBUTE MORE TO THE NATIONAL FISC. ANY ALTERATION IN THIS BALANCE MIGHT MAKE IT POLITICALLY LESS ATTRACTIVE. BAKER MAY BE MORE SYMPATHETIC TO CHANGES THAN REGAN.

7. SINCE BOTH THE ADMINISTRATION'S PLAN AND THE COMPREHENSIVE FREEZE WOULD STILL LEAVE A LARGER DEFICIT THAN DOLLARS 100 BN IN FY 88, THE QUESTION ARISES HOW SUCH A GAP MIGHT BE MET IF DOLLARS 100 BN REMAINED THE TARGET. THERE ARE A FEW PROPOSALS WHICH, ALTHOUGH RUNNING AT STAFFER LEVEL ON THE HILL, HAVE NOT YET RECEIVED POLITICAL SUPPORT. AMONGST THE MOST OBJECTIONABLE OF THESE ARE PROPOSALS FOR AN IMPORT SURCHARGE OR POSSIBLY EVEN A LEVY ON CAPITAL INFLOWS. THERE IS SOME SUPPORT IN THE MEDIA FOR A FEDERAL EXCISE TAX ON PETROLEUM PRODUCTS SUCH AS GASOLINE. LAST, STILL VERY MUCH IN THE BACKGROUND, ARE PROPOSALS FOR MORE GENERAL TAX INCREASES. ANY OF THESE COULD SURFACE DURING THE BUDGET PROCESS BUT AT PRESENT THEY ARE ONLY PART OF THE UNDERCURRENT.

COMMENT

8. THE BUDGET PROCESS HAS NOT FORMALLY BEGUN BUT ALREADY THE ADMINISTRATION HAS HAD TO ABANDON ITS INITIAL OBJECTIVE. DISCUSSIONS IN CONGRESS COULD WELL BE BASED ON THE SENATE REPUBLICANS' PROPOSALS RATHER THAN THE ADMINISTRATION'S. THE INITIATIVE HAS PASSED TO THE SENATE, WHERE 22 REPUBLICANS

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ARE ALL TOO CONSCIOUS THAT THEY WILL BE UP FOR RE-ELECTION IN 1986. THE WHITE HOUSE SEEMS TO BE CONTENT THAT THIS SHOULD BE SO, SINCE THE PRESIDENT HAS PAINTED HIMSELF INTO A CORNER BY HIS CAMPAIGN PLEDGE NOT TO CUT SOCIAL SECURITY AND HIS FAILURE TO GET WEINBERGER TO AGREE TO SUBSTANTIAL DEFENCE CUTS.-

9. THIS WOULD IN MOST OTHER COUNTRIES REPRESENT AN ABDICATION OF RESPONSIBILITY AND A SHAMBLES. BUT THE FLAVOUR EMERGING HERE IS MORE ONE OF PRESIDENTIAL OPEN-MINDEDNESS I.E. GETTING THE PRESIDENT OFF THE HOOK OF HIS OWN DEVISING SUBJECT TO A BAN ON TAX INCREASES WHICH MIGHT KILL THE RECOVERY. IT IS TRUE THAT THE PROPOSED CUTS THAT WERE ORIGINALLY LEAKED WERE SO NARROWLY BASED THAT IT SHOULD HAVE BEEN ANTICIPATED THAT THEIR EFFECTS ON THE PROGRAMMES THAT WOULD HAVE TO BEAR MOST OF THEIR BRUNT WOULD BE POLITICALLY UNACCEPTABLE. IT IS IRONIC THAT WEINBERGER, A FORMER BUDGET DIRECTOR, PLAYED SO LARGE A ROLE IN THEIR DOWNFALL. BUT NO ONE IS TALKING YET OF A MAJOR DISASTER.

10. IN MAKING THEIR PROPOSALS PUBLIC SO EARLY, THE ADMINISTRATION HAVE AT LEAST MANAGED TO PUT THE DEFICIT ISSUE HIGH ON THE POLITICAL AGENDA, PERHAPS HIGHER THAN THEY WOULD WISH. THE PRESIDENT, IN BACKING AWAY FROM HIS OWN DETAILED PROPOSALS BEFORE THEY ARE EVEN FORMALLY PRESENTED, WILL BE KEEPING HIS OPTIONS OPEN TO ACCEPT WIDER-BASED CUTS, INCLUDING THOSE IN DEFENCE AND SOCIAL SECURITY, ALTHOUGH THE LOSS OF BAKER FROM THE WHITE HOUSE MAY MAKE IT MORE DIFFICULT FOR HIM TO CONDUCT DELICATE NEGOTIATIONS WITH THE CONGRESS. (BEWARE MIRROR-IMAGING: THE US TREASURY HAS NO RESPONSIBILITY FOR THE BUDGET EXCEPT FOR TAXATION). WE ARE NOW IN THE POSITION THAT BAKER OF THE TREASURY WILL BE RESPONSIBLE FOR THE TAX REFORMS PROPOSED BY REGAN: AND REGAN AS CHIEF OF STAFF AT THE WHITE HOUSE WILL BE RESPONSIBLE FOR NEGOTIATING BAKER'S BUDGET WITH THE CONGRESS.-

11. THE CONGRESS WILL NOW HAVE TO GET DOWN TO GRIPS WITH DETAILS AND SUCCESS WILL DEPEND ON GETTING THE DEMOCRATS INTO THE ACT AT SOME STAGE. AT THE MOMENT THEY ARE NOT DECLARING WHERE THEY STAND UNTIL THEY HAVE EXPLOITED ALL THE OPPORTUNITIES FOR BLAMING THE REPUBLICANS FOR THE BUDGET CRISIS AND FOR PROPOSING THE NASTY MEASURES THAT WILL HAVE TO BE TAKEN TO DEAL WITH IT. SATISFACTORY PROGRESS WILL NOT BE MADE UNTIL THIS STAND-OFF IS RESOLVED SINCE A LONG AND DIFFICULT CONGRESSIONAL BUDGET PROCESS LOOKS TO BE IN PROSPECT AGAIN THIS YEAR, BUT I STAND BY MY PREDICTION THAT THE BUDGET DEFICIT WILL IN FACT BE REDUCED. IT IS, AS YOU WILL SEE, ALL VERY DIFFERENT FROM THE WAY WE ORDER THESE THINGS AT HOME.

12. FCO PLEASE ADVANCE TO PPS/CHANCELLOR OF THE EX CHEQUER, LITTLER AND SHIELDS (HMT), PS/GOVERNOR AND GREEN (BANK) AND BROADBENT (ESID).

FCO PSE PASS SAVING POSTS.

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