HB

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

E Y E S O N L Y

November 20, 1987

MEMORANDUM FOR HOWARD H. BAKER, JR.

FROM: BERYL W. SPRINKEL Beryl W. Sprinkel

As you suggested, I have kept up a continued conversation with Alan Greenspan concerning our common problems, and we continue to monitor closely developments in monetary policy.

I have attached a copy of an unsigned paper which I gave Alan Greenspan today. We discussed the basic approach of the paper, and he appeared to be receptive. The paper focuses on the three periods when monetary policy tightened, the market broke but the economy did not go into recession in contrast to other periods when monetary and market weakness were followed by an economic downturn. The major differences between the two groups of experiences was the fact that in non-recession experiences, monetary policy promptly eased after the market break, whereas in those cases where Fed policy remained tight for many months, a recession followed.

I will be glad to discuss this at your convenience.

Attachment

cc: James A. Baker, III

E Y E S O N L Y

November 19, 1987

Stock Market Declines and Monetary Policy

What will the aftermath of the stock market crash bring? From a reading of the historical record, it appears that the conduct of monetary policy is often the key to answering this question. If the Fed responds promptly and unambiguously to the decline with ample liquidity growth, the risk of recession will be substantially reduced.

The Fed's operations thus far have been exemplary. The Fed has proven to be in the right place at the right time by generously providing the financial system with reserves during the last month. However, it remains important that adequate liquidity growth be maintained, in the reasonable expectation that economic retrenchment or weakness may emerge as a result of the stock market break. Moreover, should signs of weakness (ambiguous though they may be) materialize, history suggests that additional policy moves would be warranted to support the economy.

In the past, periods of monetary restraint have been associated with weak stock markets, but not always with recessions. Three episodes in the postwar period where recessions were avoided after significant stock market declines are especially enlightening. In each episode, the Fed responded promptly and unequivocally with significant easing.

In late 1984, the Fed probably forestalled recession when it reversed the course of monetary policy. M1 growth had dropped sharply, from 10.2 percent in 1983 to 5.4 percent in 1984, as the Fed had tightened in an effort to keep the inflation genie in the bottle. As the Fed tightened, the stock market languished, falling roughly 12 percent over the first half of the year. In reaction to emerging weakness during the third quarter of 1984, the Fed switched direction, initially by providing reserves more freely and later by cutting the discount rate. As a result, M1 growth, which had stagnated between June and October, surged to more than an 11 percent rate over the next 4-month period. Real GNP growth, which had dipped to a 1.7 percent annual rate in the fourth quarter of 1984, also picked up, to 3.3 percent for 1985.

In 1966, when the stock market declined more than 20 percent between January and October, the Fed also reacted decisively, reversing much of its earlier tightening. Monetary policy had ended 1965 with a discount rate hike, and it became progressively tighter through September 1966. The Fed used open market operations, moral suasion, a minor increase in reserve

requirements, and reductions in retail deposit rate ceilings to slow money and credit growth. And money growth did slow: M1 growth fell from a 7 percent rate in the 6 months preceding April 1966 to a 0.7 percent rate of decline in the following 6 months. But in October, concerned by the continuing decline of the stock market and other signs of softness in economic activity, the Fed began to ease reserve availability. The economy responded to the support, and real GNP growth, although it dropped as low as a 1.0 percent rate in mid-1966, remained positive each quarter and came in at a respectable 3.2 percent for 1967.

In the spring of 1962, a sharp break in the stock market followed a significant slowdown in the rate of money growth. In the autumn, money growth rebounded, as did the stock market, and the economy slowed only briefly. During this period, the Fed was concerned about the deterioration in the U.S. external balance, and sought to induce short-term capital inflows through moderate increases in money market rates. By contrast to the gradual upward drift in short-term rates, the behavior of the monetary aggregates indicates a significant shift in Fed policy, from tightness before the stock market fall to ease thereafter. Thus the common element in all three of these episodes, where a sharp fall in the stock market has not been followed by recession, is this type of reversal in the growth rate of the money supply.

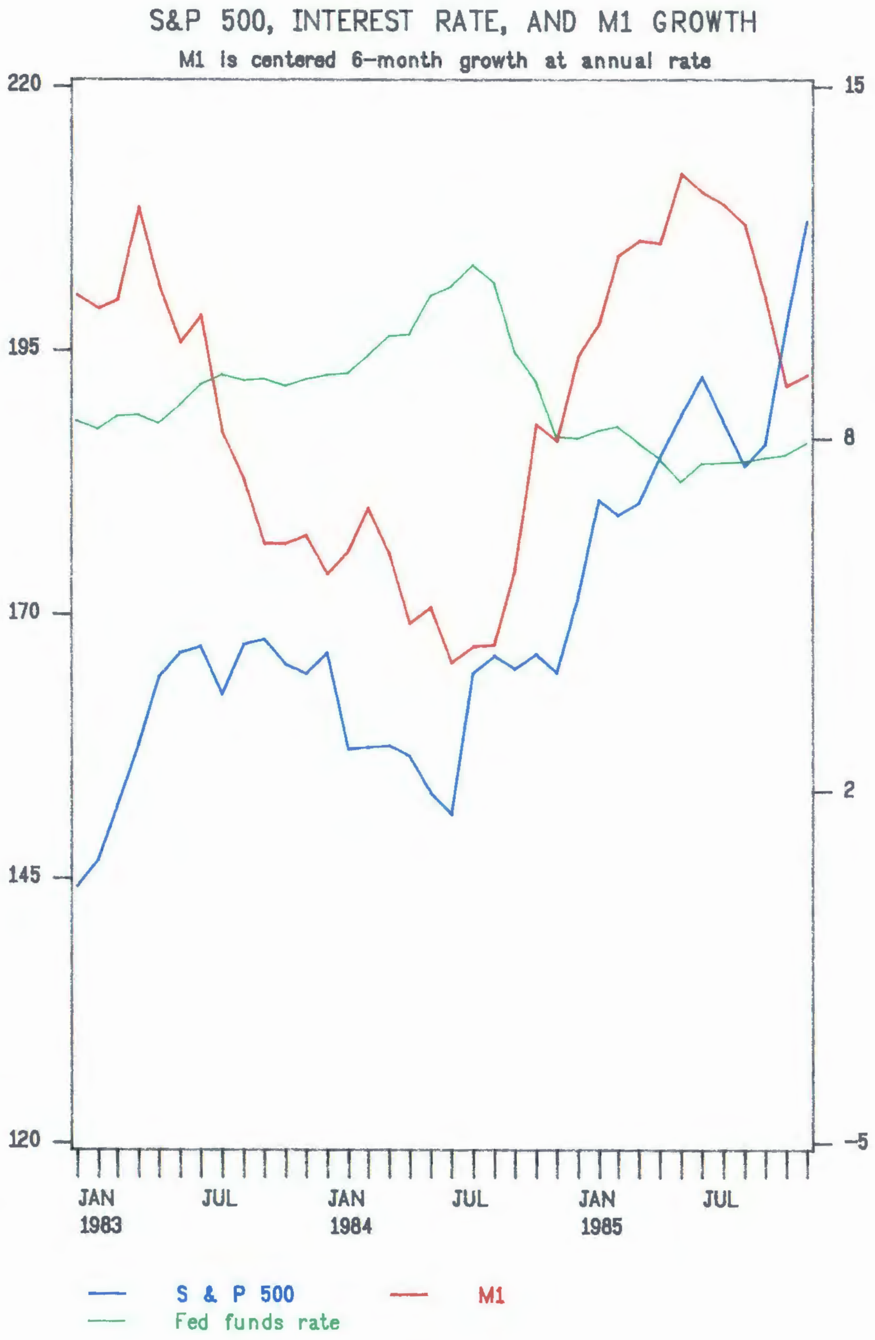
There are other occasions on which the Fed did not promptly ease policy, and economic weakness turned into recession. In current circumstances, a recession is not the answer to U.S. economic problems, and a monetary policy that lets one occur is not appropriate. Today the United States is not facing an intractable inflationary spiral that requires extreme action. And while it's true that a recession would probably reduce the trade deficit, it would also bloat the Federal budget deficit, lessen the ability of developing countries to service their debts, and undermine the financial system at a time when banks are already experiencing record loan losses.

History is open to varying interpretations, but it's safe to say that policymakers have not always recognized the true thrust of their actions. For example, interest rates can be a misleading gauge of monetary policy if economic activity weakens substantially. A constant Federal funds rate will then represent not a constant policy stance, but an ever-tighter one, as credit demand drops off.

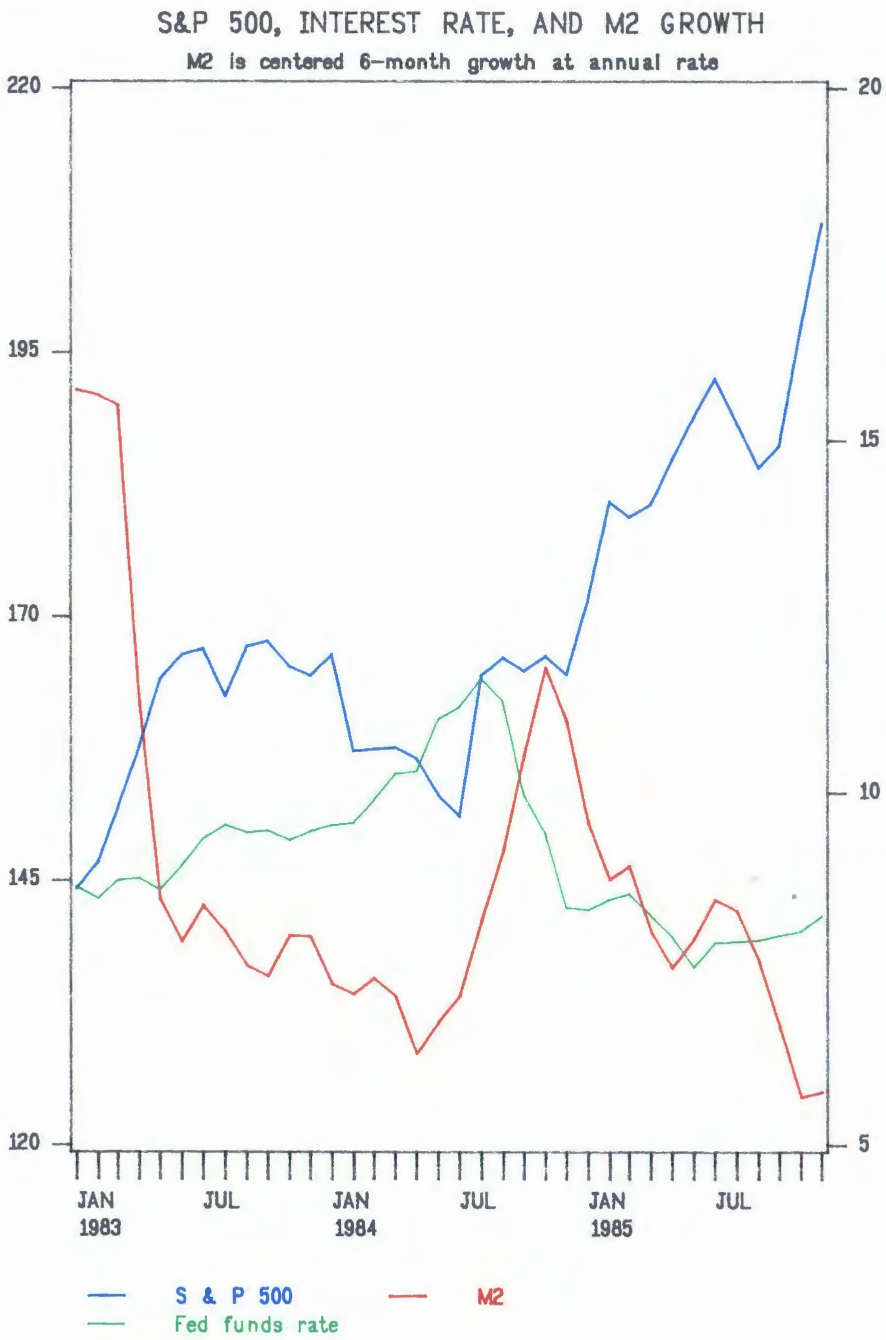
Undoubtedly, Fed policymakers intend to support the economy as it navigates the wake of the stock market crash. Nevertheless, it is important to emphasize the need for the Fed to provide ample liquidity on an on-going basis and to give additional support promptly should further signs of weakness appear. Signs of weakness in the economy are often ambiguous in first-published data, and become clearer only over time as the statistics are cleaned up. Moreover, the lags in collecting and

reporting even the first-published data, as well as the lags in the effects of monetary policy changes, demand that the Fed stay ahead of the curve to avoid a decline in economic activity.

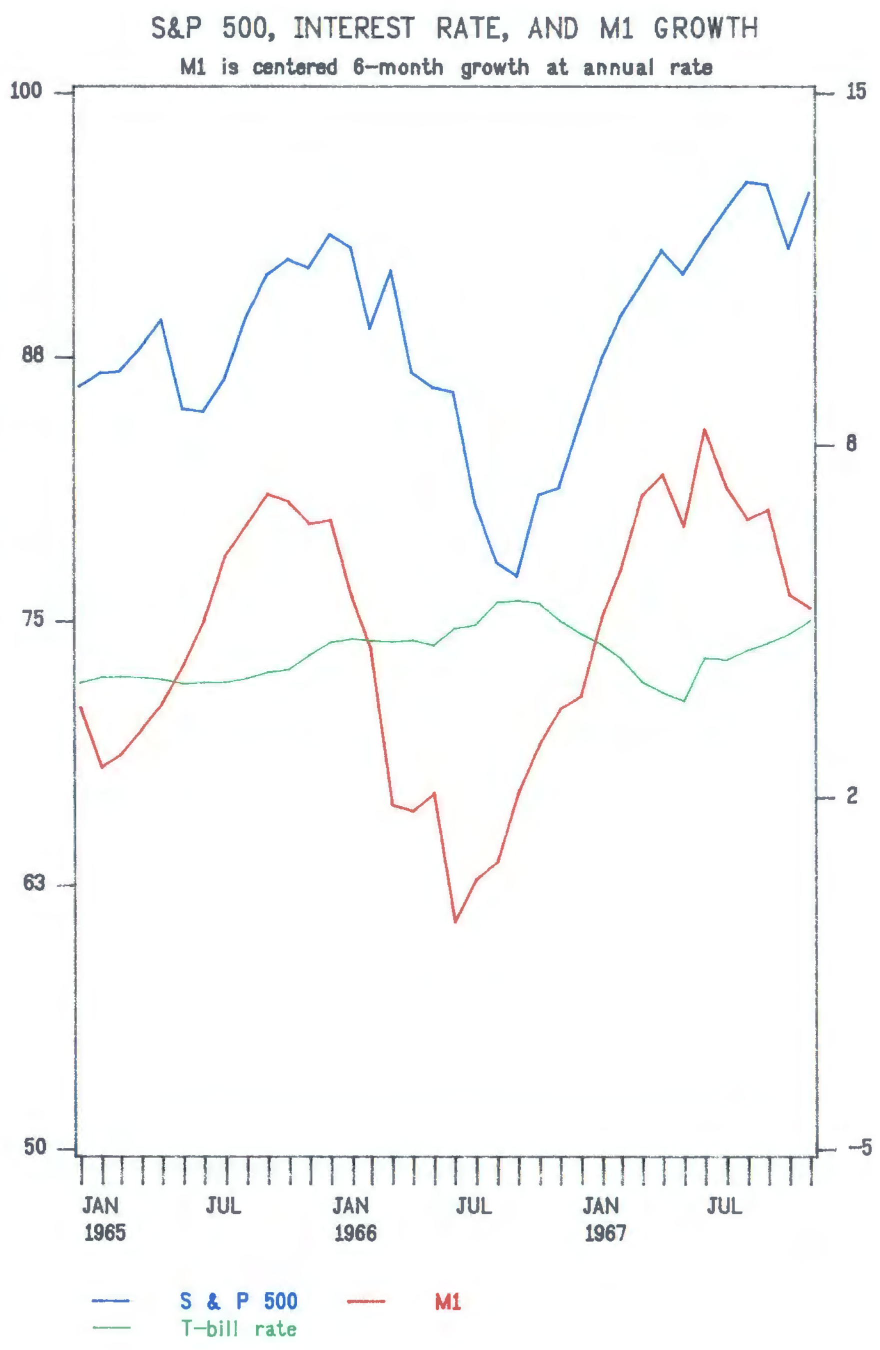
There are of course dangers in over-reacting: although the risk of inflation in 1988 has been significantly reduced, inflation has not been permanently subdued. Thus, a prescription of moderate money growth (after adjustment for a heightened demand for liquidity following the stock market crash) is in order. Specifically, M2 growth in the upper half of its tentative target range for 1988 would appear to be appropriate. The narrower aggregates should also continue to be monitored, to ensure adequate growth in transactions balances and to serve as a check on the appropriateness of M2 growth rates. Then, as the threat of recession recedes, the Fed would be well-advised to return to its long-run strategy of gradually reducing money growth rates to levels consistent with continuing progress toward general price stability while supporting sustainable economic growth.

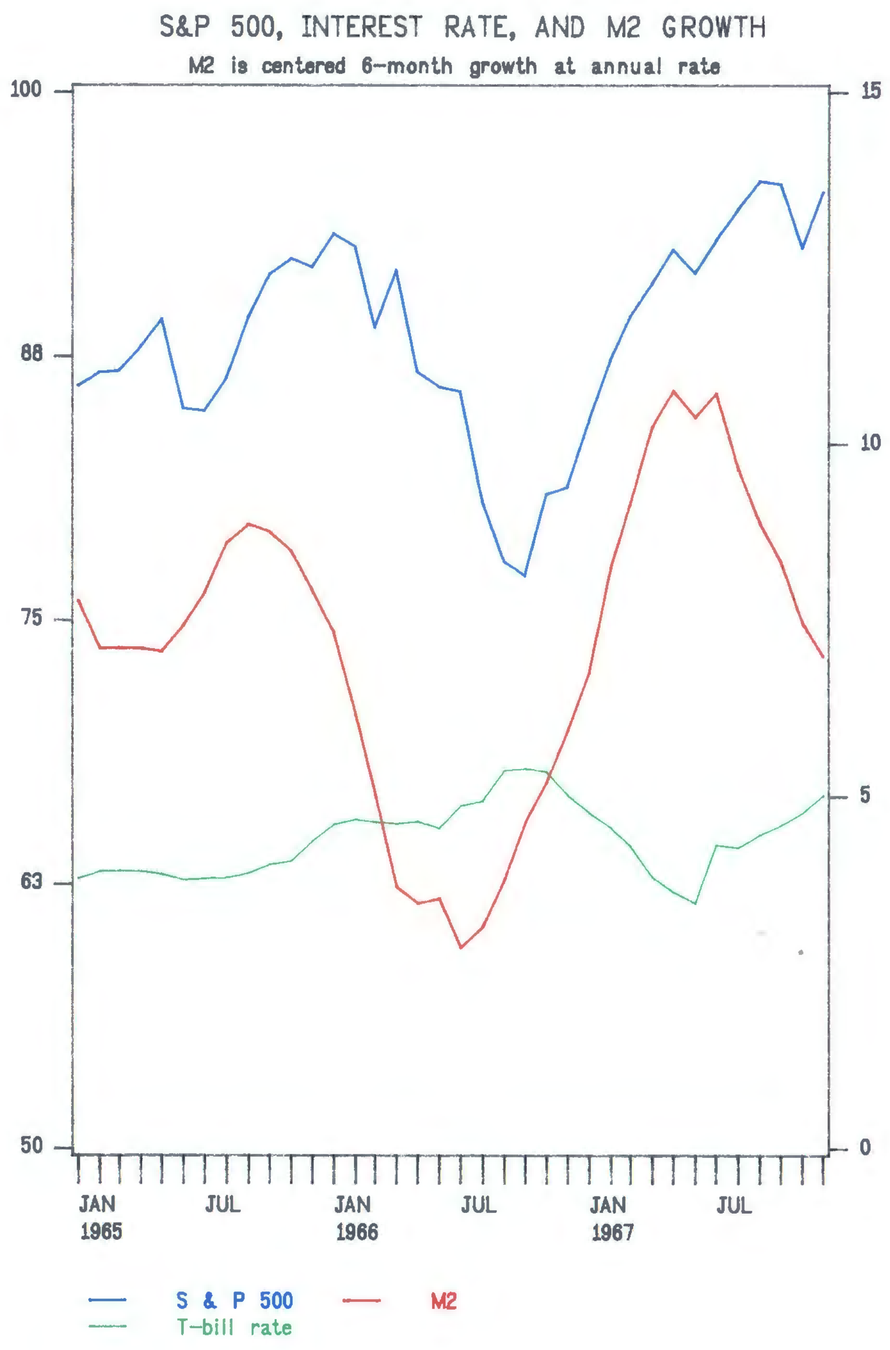


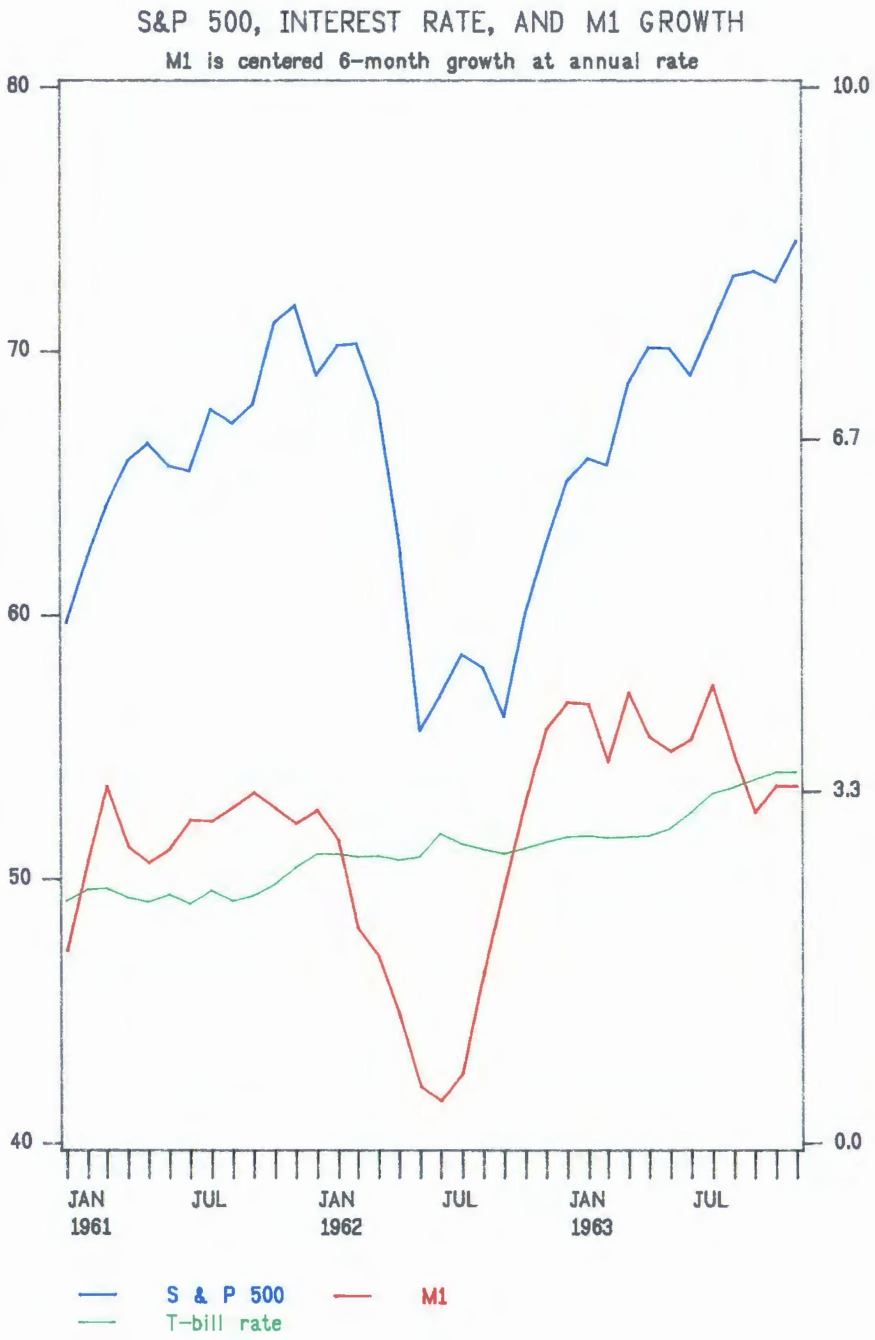
S&P 500, INTEREST RATE, AND M1 GROWTH
M1 is centered 6-month growth at annual rate
220
195
170
145
120
15
8
2
-5
JAN 1983
JUL
JAN 1984
JUL
JAN 1985
JUL
S & P 500
M1
Fed funds rate

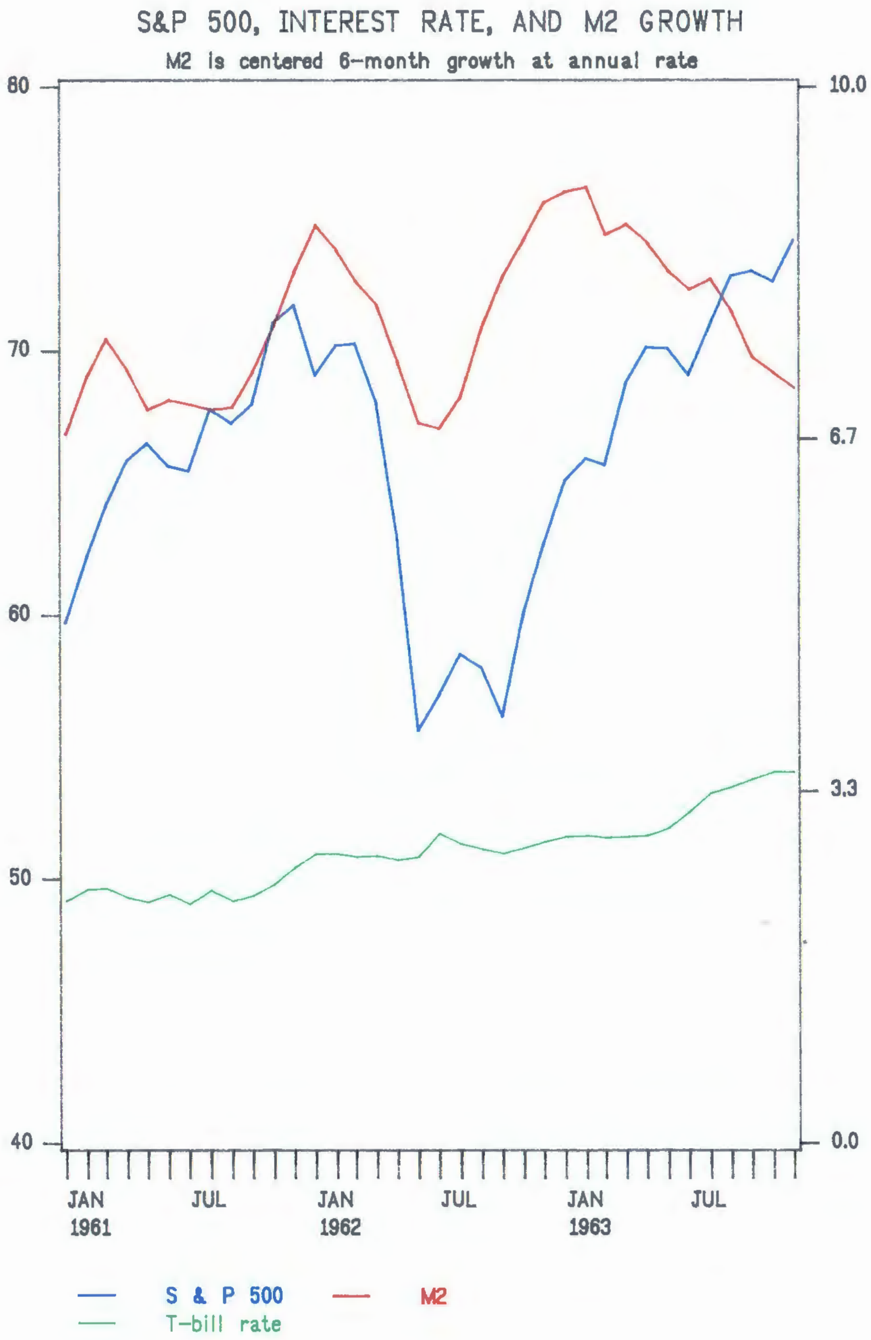


S&P 500, INTEREST RATE, AND M2 GROWTH
M2 is centered 6-month growth at annual rate
220
195
170
145
120
20
15
10
5
JAN 1983
JUL
JAN 1984
JUL
JAN 1985
JUL
S & P 500
M2
Fed funds rate


S&P 500, INTEREST RATE, AND M1 GROWTH
M1 is centered 6-month growth at annual rate
100
88
75
63
50
15
8
2
-5
JAN 1965
JUL
JAN 1966
JUL
JAN 1967
JUL
S & P 500
M1
T-bill rate

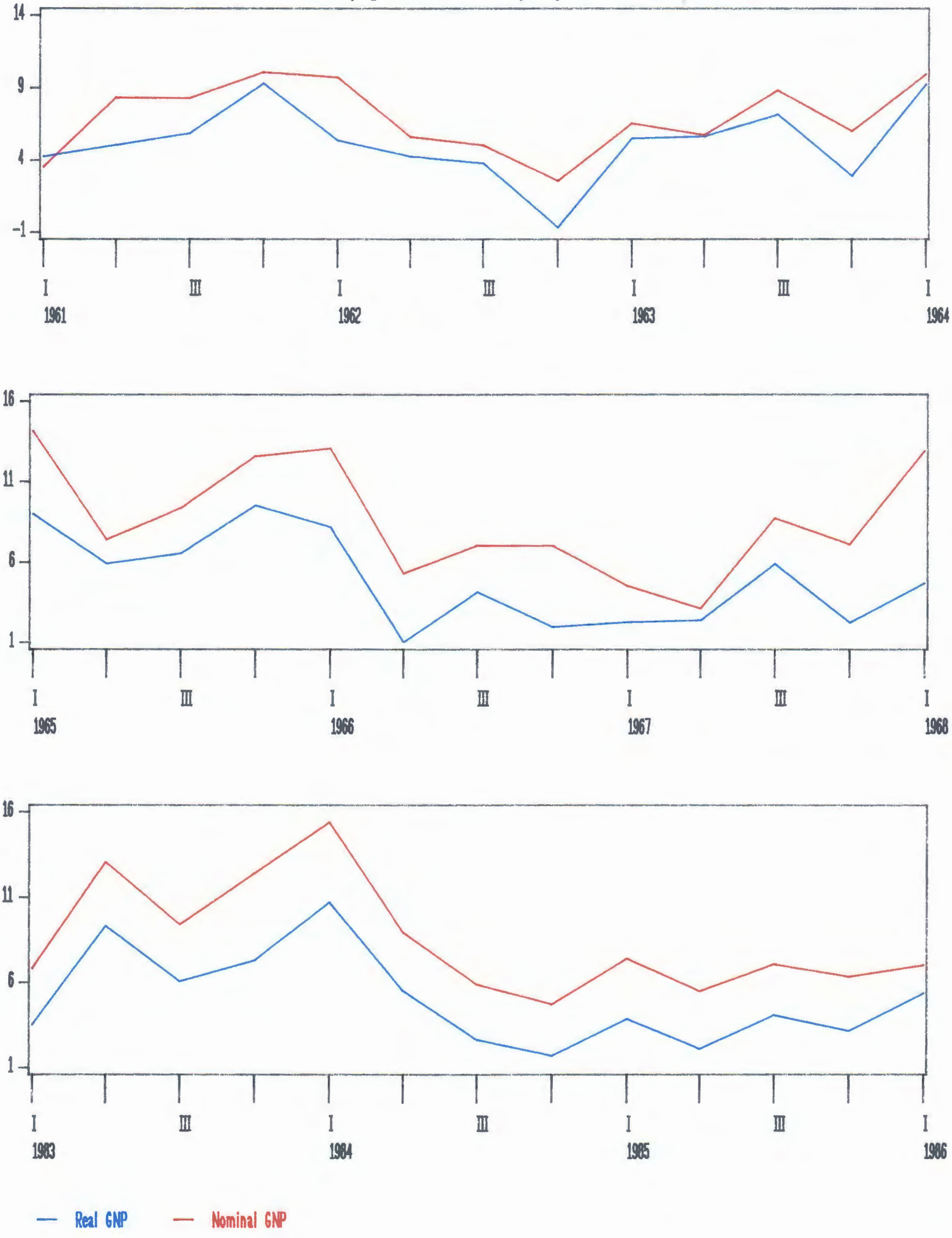

S&P 500, INTEREST RATE, AND M2 GROWTH
M2 is centered 6-month growth at annual rate
100
88
75
63
50
15
10
5
0
JAN 1965
JUL
JAN 1966
JUL
JAN 1967
JUL
S & P 500
M2
T-bill rate

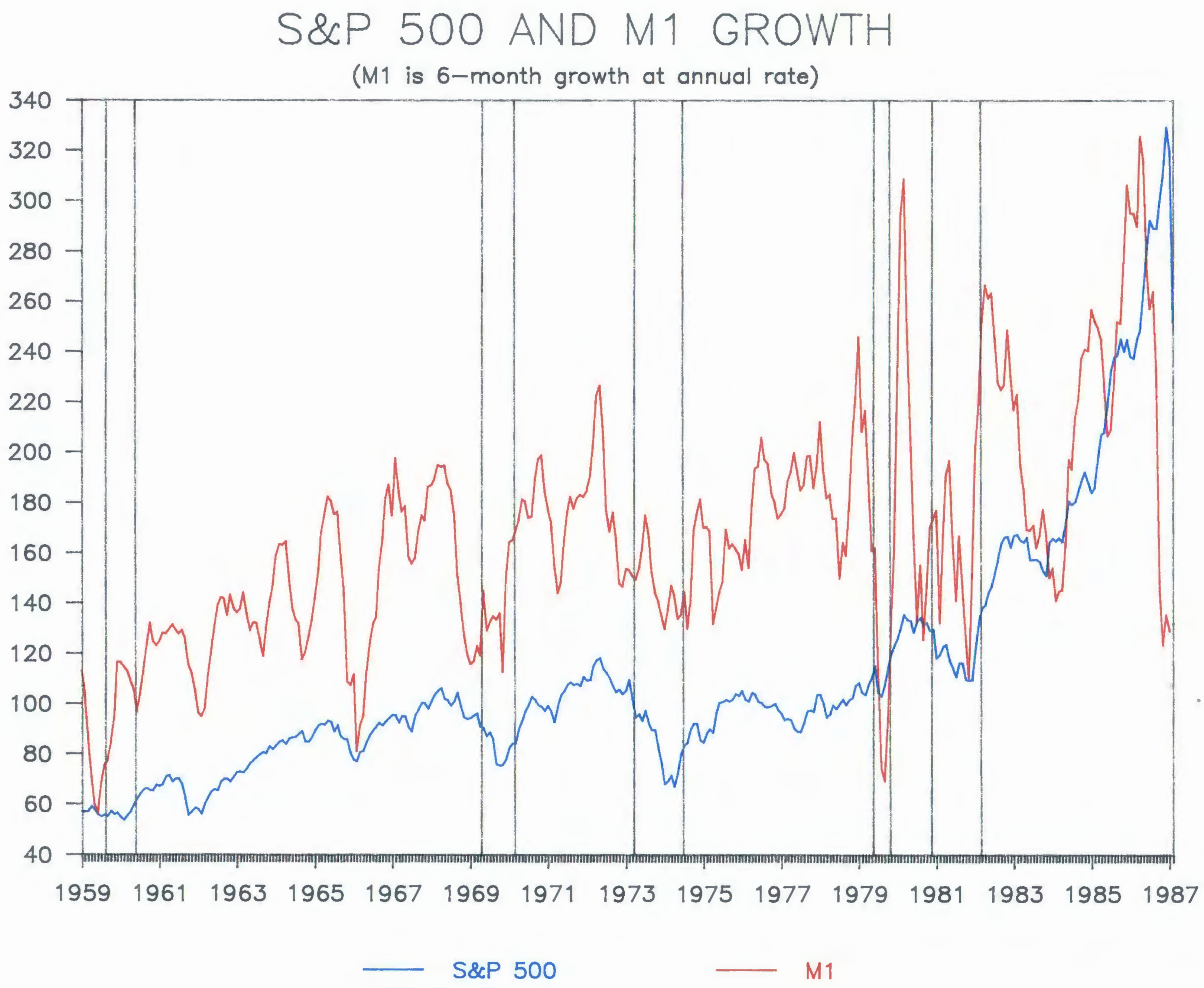

S&P 500, INTEREST RATE, AND M1 GROWTH
M1 is centered 6-month growth at annual rate
80
70
60
50
40
10.0
6.7
3.3
0.0
JAN 1961
JUL
JAN 1962
JUL
JAN 1963
JUL
S & P 500
M1
T-bill rate


S&P 500, INTEREST RATE, AND M2 GROWTH
M2 is centered 6-month growth at annual rate
80
70
60
50
40
10.0
6.7
3.3
0.0
JAN 1961
JUL
JAN 1962
JUL
JAN 1963
JUL
S & P 500
M2
T-bill rate

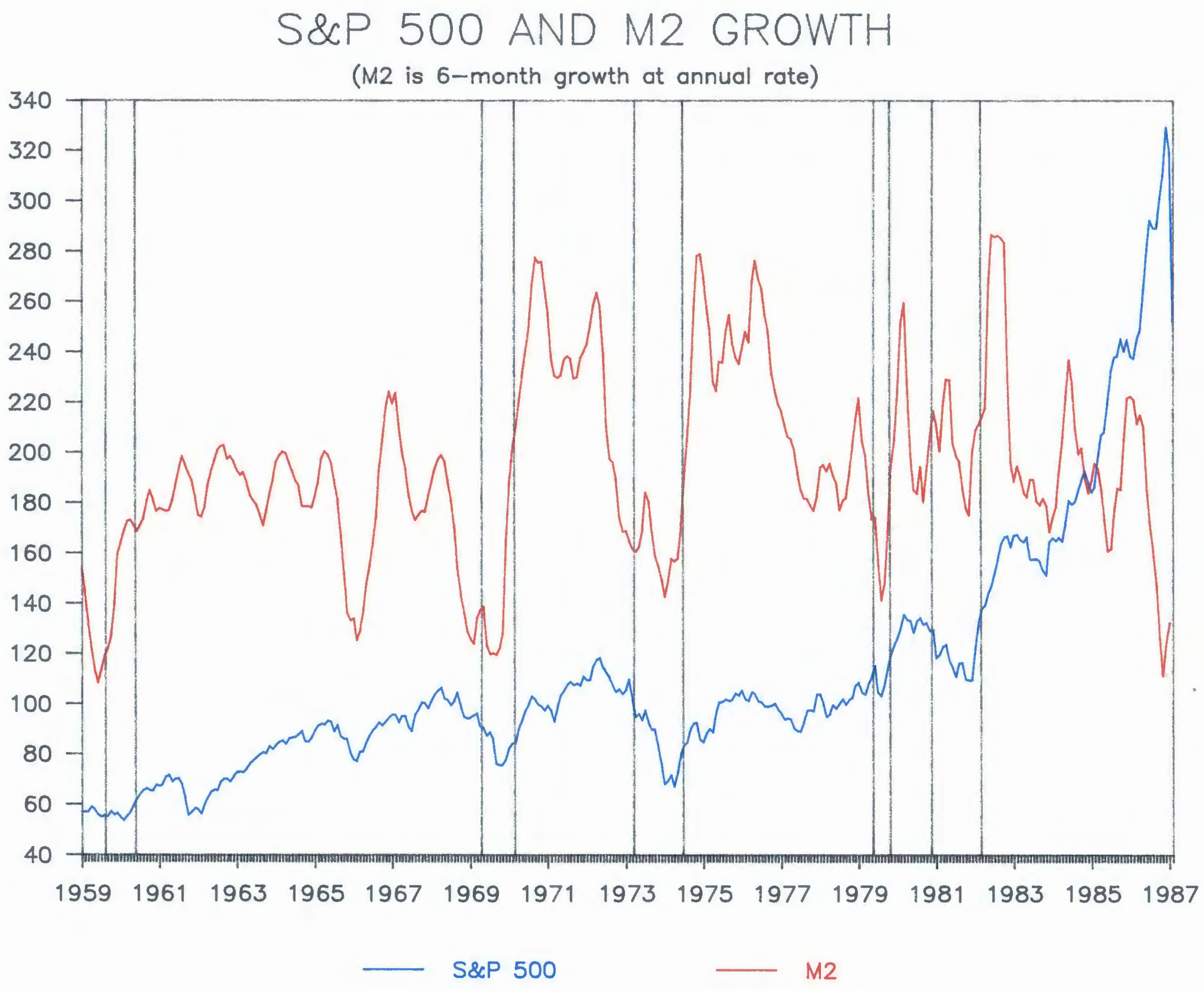
REAL AND NOMINAL GNP GROWTH

Quarterly growth at seasonally adjusted annual rates





S&P 500 AND M1 GROWTH
(M1 is 6–month growth at annual rate)
340
320
300
280
260
240
220
200
180
160
140
120
100
80
60
40
1959
1961
1963
1965
1967
1969
1971
1973
1975
1977
1979
1981
1983
1985
1987
S&P 500
M1



S&P 500 AND M2 GROWTH
(M2 is 6-month growth at annual rate)
340
320
300
280
260
240
220
200
180
160
140
120
100
80
60
40
1959
1961
1963
1965
1967
1969
1971
1973
1975
1977
1979
1981
1983
1985
1987
S&P 500
M2

11-18-87
took in to
KR

11/12/87

479-3074

Sue:

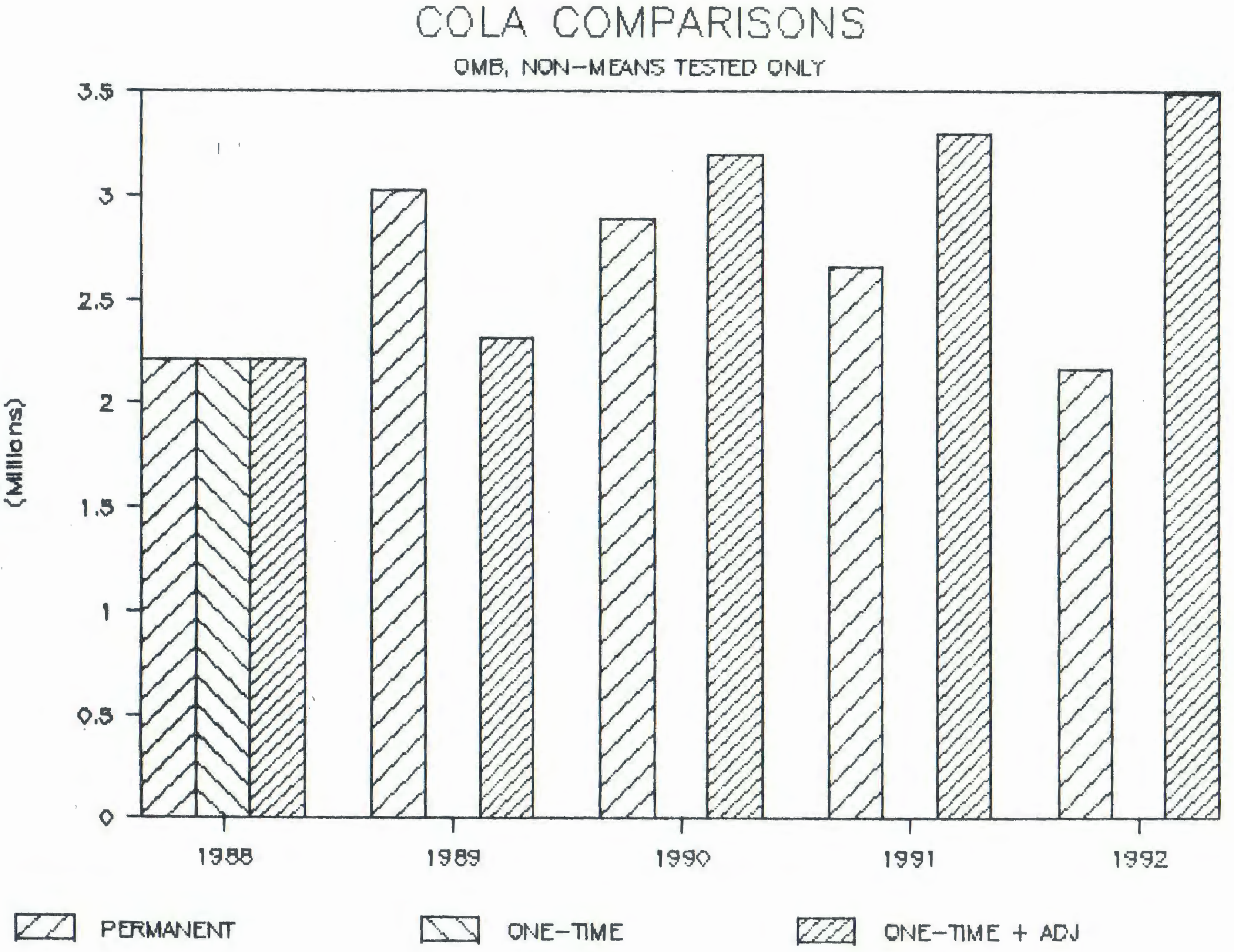
When Senator Baker sees Secretary Baker, please remind him to MENTION TO JIM BAKER HHB'S PHONE CONVERSATION WITH TOM JONES 11/12 REGARDING THE CONTRACT METHOD OF ACCOUNTING.

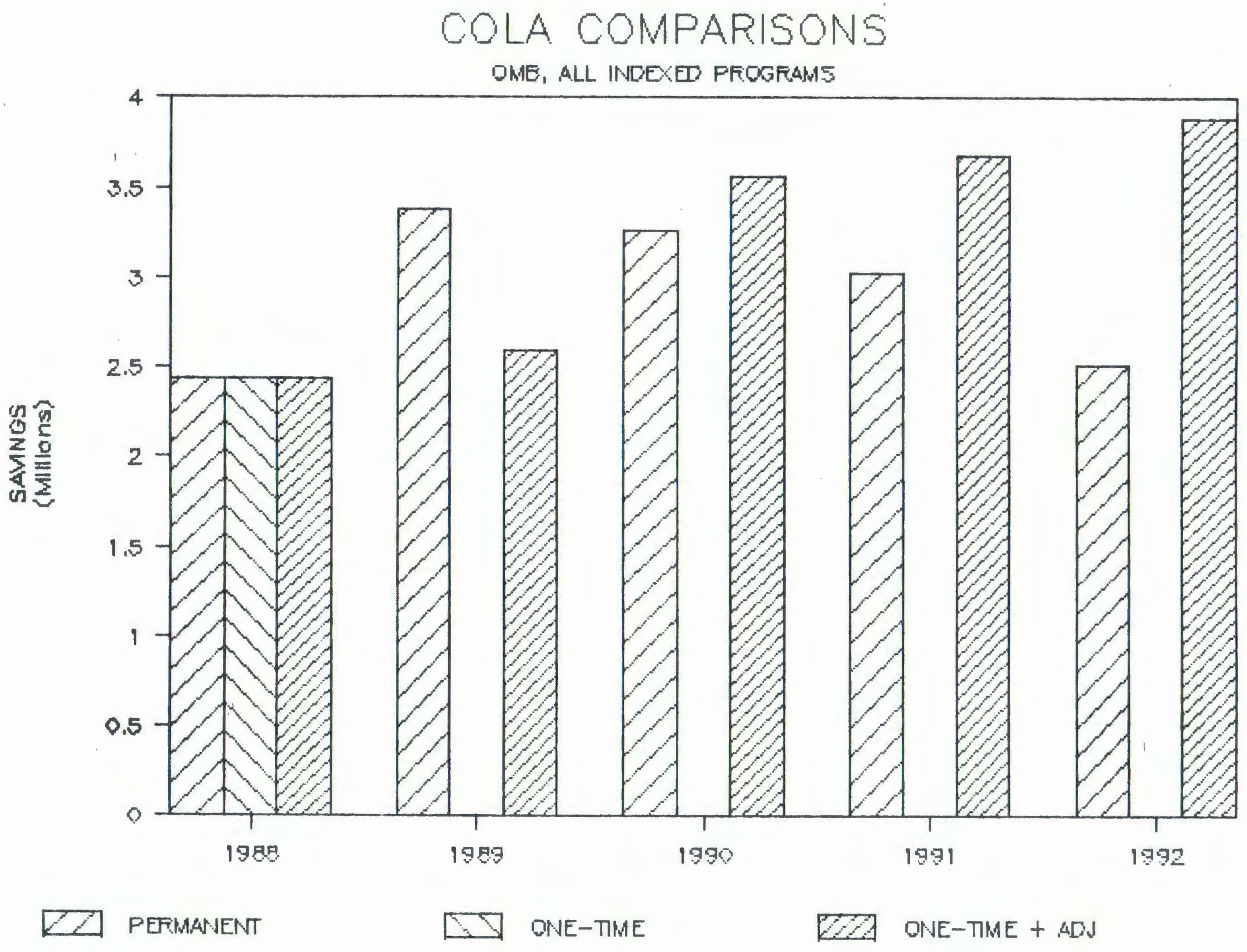
Susan

AB

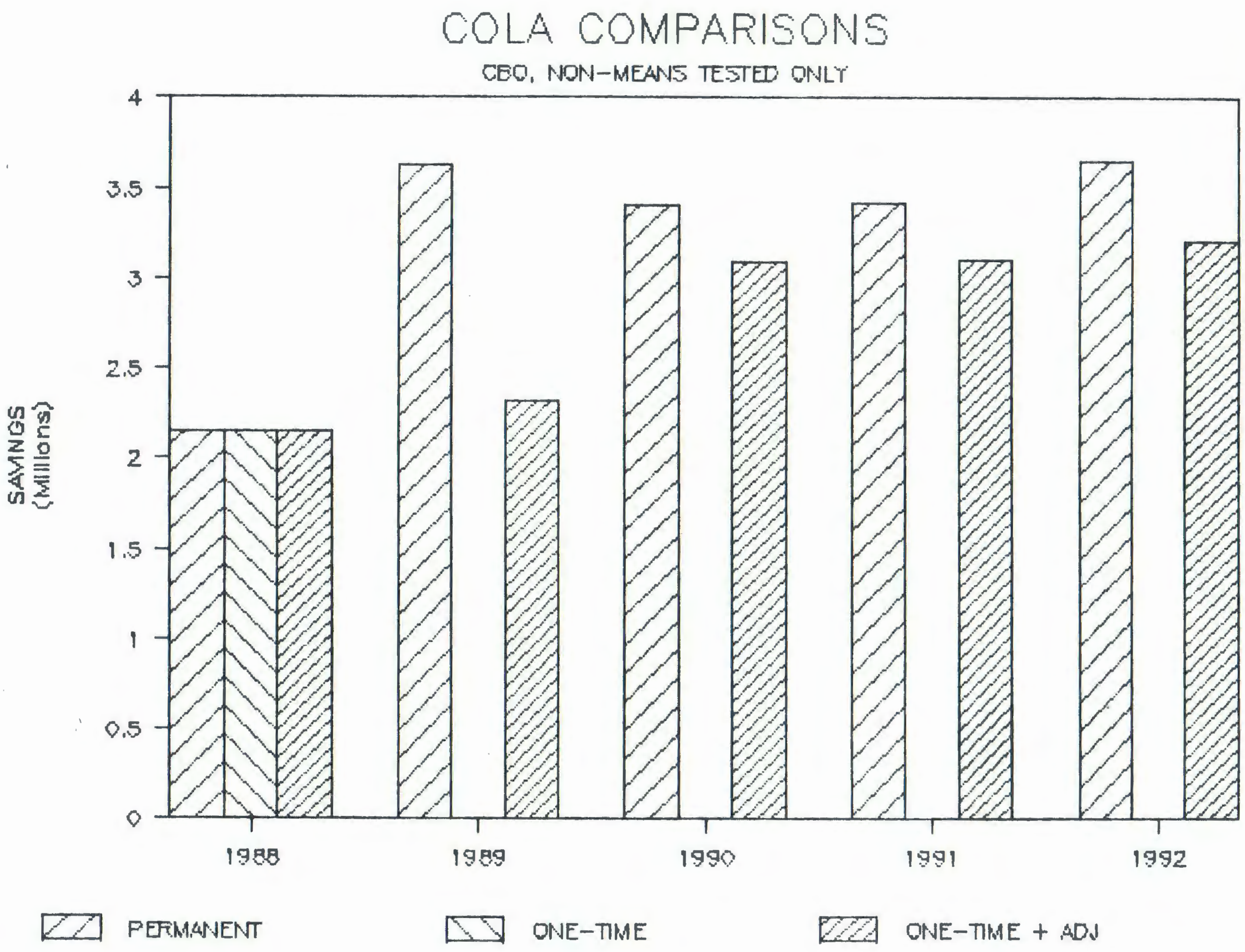
COLA COMPARISONS
(Savings from GRH baseline,
in millions of dollars)

	1988	1989	1990	1991	1992
Permanent 3 month slip					
Non-means tested programs only					
OMB	-2216	-3020	-2892	-2664	-2169
CBO	-2144	-3625	-3412	-3422	-3647
Difference	-72	605	520	758	1478
All indexed programs					
OMB	-2437	-3385	-3256	-3021	-2513
CBO	-2321	-4062	-3804	-3801	-4047
Difference	-116	677	548	780	1534
One-time 3 month slip					
Non-means tested programs only					
OMB	-2216	0	0	0	0
CBO	-2144	0	0	0	0
Difference	-72	0	0	0	0
All indexed programs					
OMB	-2437	0	0	0	0
CBO	-2321	0	0	0	0
Difference	-116	0	0	0	0
One-time 3 month slip & adjusted 89 COLA					
Non-means tested programs only					
OMB	-2216	-2311	-3202	-3296	-3495
CBO	-2144	-2316	-3094	-3098	-3212
Difference	-72	5	-108	-198	-283
All indexed programs					
OMB	-2437	-2591	-3559	-3678	-3895
CBO	-2321	-2710	-3509	-3540	-3692
Difference	-116	119	-50	-138	-203

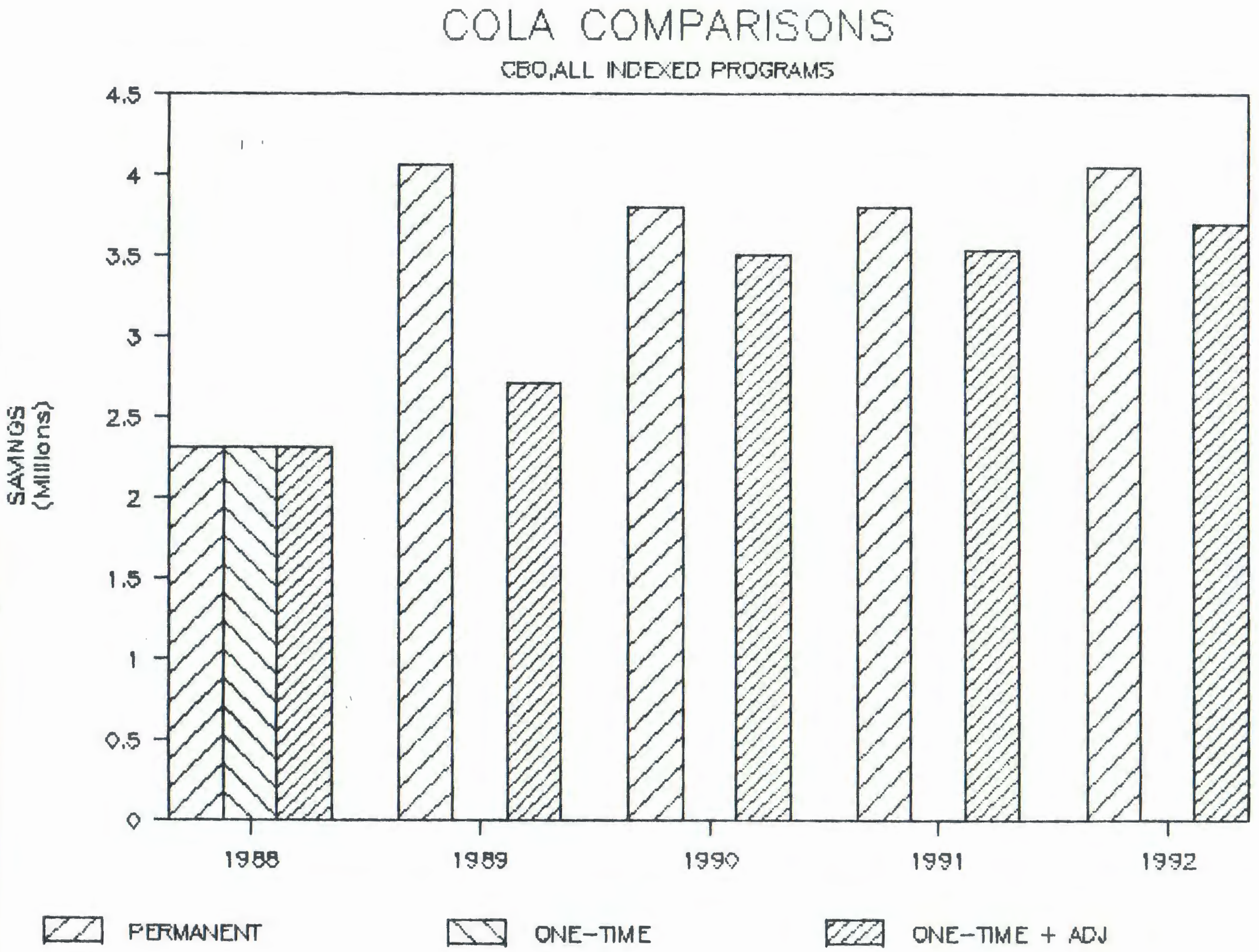

COLA COMPARISONS
OMB, NON-MEANS TESTED ONLY
SAVINGS (Millions)
3.5
3
2.5
2
1.5
1
0.5
0
1988
1989
1990
1991
1992
PERMANENT
ONE-TIME
ONE-TIME + ADJ



COLA COMPARISONS
OMB, ALL INDEXED PROGRAMS
SAVINGS (Millions)
4
3.5
3
2.5
2
1.5
1
0.5
0
1988
1989
1990
1991
1992
PERMANENT
ONE-TIME
ONE-TIME + ADJ



COLA COMPARISONS
CBO, NON-MEANS TESTED ONLY
SAVINGS (Millions)
0
0.5
1
1.5
2
2.5
3
3.5
4
1988
1989
1990
1991
1992
PERMANENT
ONE-TIME
ONE-TIME + ADJ

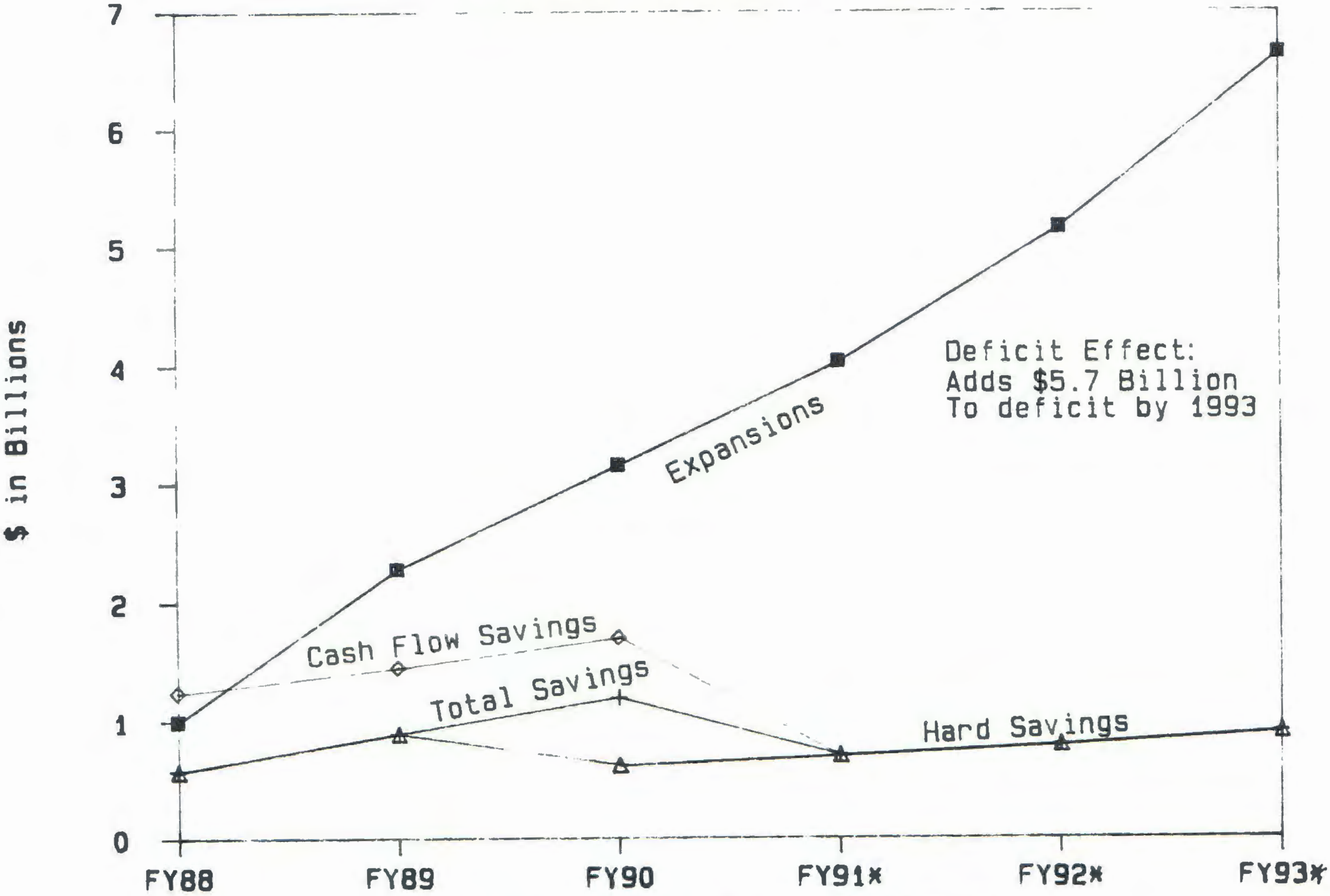


COLA COMPARISONS
CBO,ALL INDEXED PROGRAMS
SAVINGS (Millions)
4.5
4
3.5
3
2.5
2
1.5
1
0.5
0
1988
1989
1990
1991
1992
PERMANENT
ONE-TIME
ONE-TIME + ADJ

Medicare + Medicaid

House Reconciliation

Expansions Overwhelm Real Savings



Source: Administration Estimates
* Preliminary Estimates

■ Expansions	+ Savings
◇ Cash Flow	△ "Hard" Savings

House Reconciliation

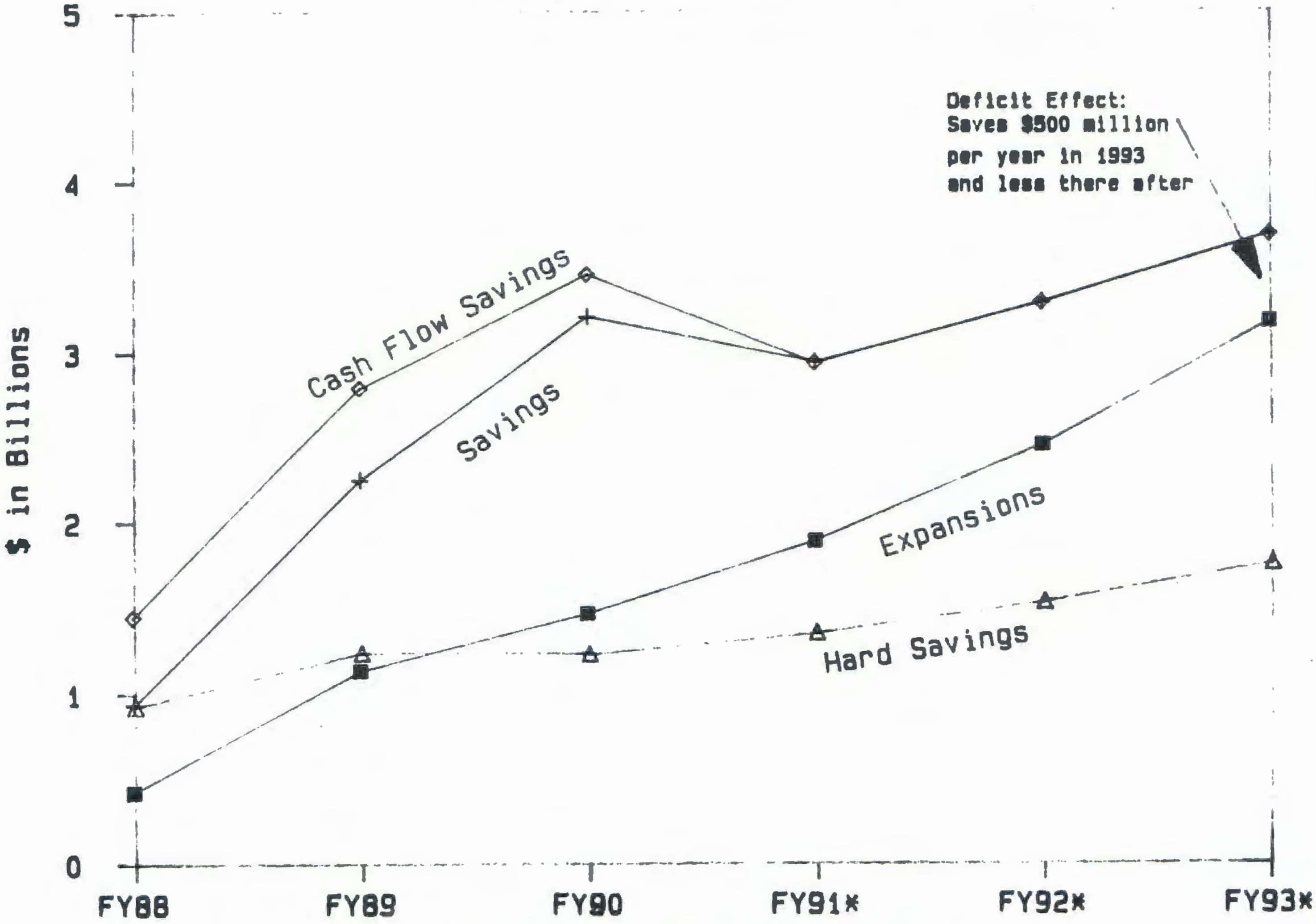
MEDICARE & MEDICAID

	Administration Estimates ($ in millions)					
	FY88	FY89	FY90	FY91	FY92	FY93
Expansions	1,007	2,296	3,167	4,042	5,175	6,642
Total Savings including cash flow	(1,245)	(1,460)	(1,710)	(1,447)	(1,599)	(1,769)
Cash flow savings: prompt pay	(670)	(560)	(510)	(110)	(110)	(110)
Incurred cost savings	(575)	(900)	(1,200)	(1,337)	(1,489)	(1,659)
Savings from extending current law:						
Extend hospital capital into FY90	0	0	(585)	0	0	0
Hard Savings	(575)	(900)	(615)	(1,337)	(1,489)	(1,659)

Medicare + Medicaid

Senate Reconciliation

Expansions Overtake Savings



Source Administration Estimates

* Preliminary Estimate

■ Expansions
◇ Cash Flow
+ Savings
△ "Hard" Savings

Senate Finance	Administration Estimates ($ in millions)					
MEDICARE & MEDICAID	FY88	FY89	FY90	FY91	FY92	FY93
Expansions	427	1,136	1,470	1,896	2,452	3,179
Total Savings including cash flow	(1,452)	(2,801)	(3,456)	(3,656)	(4,064)	(4,517)
Cash flow savings:						
Prompt Pay	(520)	(190)	(210)	(60)	(60)	(60)
Eliminate some periodic payments	0	(365)	(40)	(25)	(25)	(25)
Incurred cost savings	(932)	(2,246)	(3,206)	(3,571)	(3,979)	(4,432)
Savings from extending current law:						
Continue Part B premium at 25% of program costs	0	(1,000)	(1,400)	(1,580)	(1,750)	(1,920)
Extend hospital capital into FY90	0	0	(570)	0	0	0
Hard Savings	(932)	(1,246)	(1,236)	(1,991)	(2,229)	(2,512)

Out
AP 11/17/87

Key Elements

1. GNP rising @ or above rates of other OECD countries
2. Inflation moved up to 5% level but apparently now level off @ that rate
3. High federal deficit with danger of bouncing up after big decline
4. Net private savings more or less sopped up by federal deficit
5. Investment therefore financed from abroad.
6. The trade deficit is a sort of counterpart of the net inflow of capital from the world savings pool

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7. All numbers are large by any human, past, or other country standard — BUT not necessarily in relation to the US economy

Expectations

1. The trade deficit cannot go on for much longer so something must happen to reduce it

2. The budget deficit is distorting the allocation of resources ~~at~~ so something must be done to reduce it — or keep a reduction path clear

3. Policy options are fairly clear and markets feel great uncertainty about what is likely to happen
   - with some options coming in to being by default and resulting in unfavorable developments.

4. Any major fall off in US economic performance will mean
   - a ballooning deficit
   - great problems for an export-dependent world economy
   - all aggravated dramatically by debt

Options and Their Problems

1. Remember the 1930's = tax increases + tight money + protection = depression and the tension and confrontation that produced WW II.

2. The budget deficit cannot be credibly dealt with without some tax changes but this is not really the heart of the problem

3. The Louvre argument to maintain currency values means tight money in the U.S., especially since Germany and Japan either will not or cannot expand their economies by easier money and lower interest rates

4. Protection looms

5. A

What Must Be Done

1. Sensible budget reduction pattern established
   = cut into entitlements
   some tax increases
   based on X-C agreement and
   therefore believable.

2. Stop talking about currency values
   = don't convene G-7

3. Make clear monetary policy will be accomodative

4. Stop ~~prot~~ protectionist movement

NOVEMBER 16 STATUS
(savings from G-R-H baseline, in billions of dollars)

Item	FY 1988	FY 1989
Revenue increases:		
Receipts	10.0	13.0
IRS Compliance	1.6	2.9
User Fees	1.1	1.4
Subtotal, revenues	12.7	17.3
Outlay Reductions:		
Discretionary programs:		
Defense	5.0	8.0
Domestic & International	2.6	4.0
Subtotal, discretionary	7.6	12.0
Entitlement programs:		
Senate bill (with payment shift)	1.7	3.0
Medicare	.3	.5
Agriculture	.9	1.6
COLA's (3-month shift)	2.1	2.3
Subtotal, entitlements	5.0	7.4
Subtotal, outlays	12.6	19.4
Asset Sales	5.0	5.0
VA loans	1.0	1.0
Debt service	1.3	4.0
Total deficit reduction	32.6	46.7

COMPROMISE PROPOSAL
(savings from G-R-H baseline, in billions of dollars)
November 17, 1987

Item	FY 1988	FY 1989
Revenue increases:		
Receipts	10.0	13.0
IRS Compliance	1.6	2.9
User Fees	1.1	1.4
Subtotal, revenues	12.7	17.3
Outlay Reductions:		
Discretionary programs:		
Defense	4.75	8.0
Domestic & International	2.6	4.0
Subtotal, discretionary	7.35	12.0
Entitlement programs:		
Senate bill (with payment shift)	1.7	3.0
Medicare	.3	.5
Agriculture	.9	1.6
COLA's (3-month shift)	2.1	2.3
Subtotal, entitlements	5.0	7.4
Subtotal, outlays	12.35	19.4
Asset Sales	5.0	5.0
VA loans	1.0	1.0
Debt service	1.3	4.0
Total deficit reduction	32.35	46.7

Other Requirements

1) Enforcement provisions to insure savings are real and lasting, including:

   - 2-year appropriations restraints.
   - prohibition on provisions that increase the deficit--revenue losers and spending increases.

2) Each provision of the $10 billion in gross taxes must be acceptable to the President.

	R1	IRS	R2	R3	050	150	Domestic Disc.	Entitle-ments	VA & Debt	Total	
Chiles 1	10	2	2	5.3	3.5	1	1.8	3.7	2.1	31.4	
Michel	6	2	1.4	4.1	4.9	0.4	4.1	5.1	2	30	
House D's	12	1.6	1.3	5.3	5.4	1	1.4	3.5	2.2	33.7	
Chiles 2	10	1.6	1.4	5.4	4.5	1	1.8	4.1	2.1	31.9	1/
Packwood/Gray	9	1.6	1.5	5.4	5	0.6	2	3.3	2.1	30.5	1/
Chiles 3	10.4	1.6	1.5	5.4	4.4	0.7	2	3.6	2.1	31.7	1/
Panetta/Chiles	10	1.6	1.5	5	4.5	0.6	2	5	2.2	32.4	1/
Panetta et al	11.5	1.6	1.1	5	5	0.6	2.65	5	2.2	34.65	1/
Nov. 16 Status	10	1.6	1.1	5	5	0.6	2	5	2.2	32.5	1/
Admin. Counter	10	1.6	1.1	5	4.75	0.6	2	5	2.2	32.25	1/
Sequester (pre-'88 supp.)					13.5	1.2	7.6	3.1	0.9	26.3	2/

1/ total includes .5 Medicare payment shift scored as entitlement
2/ includes savings due to actual appropriations below the baseline

ELEMENTS FOR A CONGRESSIONAL-ADMINISTRATION
LEADERSHIP MEMORANDUM OF UNDERSTANDING

1. Amend the Congressional Budget Act to limit discretionary spending in FY 1988 and 1989. Such amendment must:

   - apply to both Houses;
   - establish separate allocations for defense (including 150) and domestic spending;
   - include caps on both budget authority and outlays;
   - apply caps to discretionary spending only;
   - establish allocations for both FY 1988 and 1989;
   - allow adjustments for economic and technical reestimates for FY 1989 for defense if allowed for domestic.

2. Amend the Budget Act to create enforcement mechanisms which would bind both Houses. Two new points of order have been proposed:

   - One would prohibit the consideration of legislation in the Senate or House which would breach the overall defense and domestic allocations for FY 1988 and 1989.
   - The second would prohibit the consideration of legislation in the Senate or House which would cause a committee or subcommittee to exceed its allocation under the defense and domestic caps for FY 1988 and 1989.
   - Neither could be waived in the Senate or House except with a three-fifths vote.

3. Agree that Congress will appropriate sufficient budget authority for defense in FY 1988 and 1989 to yield a minimum level of outlays (equal to the outlay allocation for defense). Adopt Senator Johnston's proposal for a pro rata reduction in domestic if defense does not receive its full allocation.

4. Provide that Section 302(a) allocations under the FY 1989 budget resolution must be consistent with the defense and domestic allocations outlined in #1 and make this requirement enforceable in both Houses.

5. Commit not to initiate any supplementals, except for true emergencies (defined not to include pay increases).

6. Adopt a resolution or revise the FY 1988 budget resolution to bring totals into line with this agreement for purposes of Budget Act compliance. Agree that the Appropriations Committees will submit revised allocations for FY 1988 under Section 302(b) of the Budget Act.

7. Agree that the President will not veto -- for budget reasons -- any FY 1988 or 1989 appropriation bill which is consistent with this agreement.

8. Eliminate deficit increases in existing reconciliation bills and agree that new language not include any such increases.

9. Agree to measures which would present the continuing resolution and reconciliation to the President either as one bill or within less than ten days of one another.

November 12, 1987

November 16, 1987

TO : Senator Baker
FROM : Dan
RE : Attached Budget Material

We are within striking distance of "agreeing" on the broad parameters of a deal. The first page details where we finished this evening—it includes a 3-month COLA freeze. Jim Baker wants to respond affirmatively, changing only the defense number by adding $250 million to 1988 outlays. Frank is less concerned about 1988 than 1989. He would prefer to add 1989 budget authority in any final deal. Obviously, virtually whatever we do is better than a sequester (and the prospect of a sequester next year). The Jim Baker plan is is the second page.

If we chose to agree, as you have been saying, it is critical to know what the tax bill will include. It is almost as critical to eliminate the program expansions included in both reconciliation bills. Thus, we have included the "other conditions" precedent to a deal on the bottom of the Jim Baker plan.

You should be able to determine how serious either Wright or Byrd are by getting their commitment to:

1) eliminating all program expansions and revenue losers from the final package; and,

2) not allowing Pepper a separate vote in the House on COLA's.

I remain of the opinion that we should "halt" the current talks and meet with Bentsen/Rostenkowski to work out the tax bill and the program expansions. If Byrd and Wright would agree, it would be much easier to reach final resolution, with or without COLA's.

The last two pieces of the package are the Domenici list of enforcement issue and our current "scorecard" of the various plans.

ENFORCEMENT ISSUES

November 11, 1987

Must have–

- Caps on domestic appropriations for both 1988 and 1989, enforceable in both Houses in both BA and outlays. The Senate has agreed, but the House is balking.

- There must be a separate allocation for defense. To insure the full amount is appropriated, we need a floor for defense spending in 1988 and 1989. Sen. Johnston's proposal for a pro-rata reduction in domestic if defense does not receive its full allocation is acceptable.

- For international, the allocation must be separate from domestic, including the allocation for the State Department in the Commerce, State, Justice bill. (This allocation could be part of the overall defense allocation.) Brandon has said that they cannot promise appropriaton of any additional amounts for State in the C,J,S bill.

- The 1989 allocations must occur at the same time as the reallocation for 1988 by adoption of separate 302(a)'s for domestic and defense (including international).

- Deficit increases in reconciliation must be eliminated. Given the minimal domestic cuts, this point should be non-negotiable.

- Outlay shifts and user fees should not count toward promised spending reductions.

- No supplementals, except for true emergencies.

Should have–

- Agreement to hold off on CR until all elements of plan in place, including agreement on tax bill.

- All appropriations should be sent to President before reconciliation/tax bill.

- Agreement to exclude all extraneous language from appropriations bills.

- Agreement on scoring for savings. Appropriations will not be a problem. On reconciliation, HHS and CBO should be ordered to come to agreement on Medicare and Medicaid scoring, and split the difference on any remaining disagreement. Because CBO, following the direction of Finance and Ways and Means, understates the costs of add-ons, an agreement on scoring is a "must have" if we do not get agreement to drop all program expansions.

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release November 13, 1987

STATEMENT BY THE ASSISTANT TO THE PRESIDENT FOR PRESS RELATIONS

The President commends the Senate's vote for fiscal restraint by its refusal to waive the budget act for the housing bill. This measure is clearly at odds with efforts to reduce the deficit. At this juncture in budget negotiations, ~~I~~it is encouraging to see 40 members of the Senate willing to vote against increasing the deficit despite pressures from special interest groups.

# # #

[Possible last paragraph]

[Should this legislation reach the President's desk in its current form, it will be vetoed because of the impact its provisions will have on deficit spending for years to come.]

11-9-87

Harrison/ Johnson

SAVINGS (excludes interest)	FY 1988	FY 1989
Spending		
Appropriations	6.9	12**
Nondefense	(2.5)	(6.0)*
Defense	(4.4)	(6.0)*
Entitlements	9.3	24.7
Revenues		
R 1s	11.8	19.6 - 23
R 2s (user fees & asset sales)	5.8	5.8
TOTAL	33.8	62.1-65.5

**Numbers followed by asterisk are tentative projections and will be finalized when baseline is settled.

CONCEPT:

1. Match Nondefense S cuts with R1s
2. Match buy back from defense sequester with R2s

SPENDING OPTIONS

CATEGORY	TOTAL SAVINGS FY 88	TOTAL SAVINGS FY 89
A. Nondefense Discretionary	-2.5	-6.0*

FY 1988 cut equal to 30% of amount to be sequestered in nondefense discretionary accounts

Requires cuts of 2.5 billion, or about 2.6% below baseline

Requires cut of between 2.6 and 2.7 billion from the mid point between House-passed and Senate-passed or Senate reported bills, or a cut of 2.6 -2.7% in outlays

FY 1989 outlays --2% nominal growth

B. Defense Discretionary	-4.4	-6.0*

FY 1988 cut equal to 40% of amount to be sequestered

BA 292.2
O 286

FY 1989 -2% nominal growth in outlays

BA 298.1
O 292.2

** 1989 numbers are tentative since 1989 baseline not yet certain.

C. ENTITLEMENTS REFORM OPTIONS

	TOTAL SAVINGS	
	FY 88	FY 89
Current Senate reconciliation bill, less user fees	-1.5	-2.6
Remove increases in reconciliation	-0.4	-1.0
Farm programs	-0.9	-1.6
Food stamps (administrative savings)	-0.3	-0.3
Medical programs	-0.5	-0.9
Government student loans (bank reserves)	-0.2	-0.1
Federal work force reform (Chiles/Gray package)	-0.4	-1.9
Veterans loan programs (make loan sales nonrecourse) (OMB estimate)	~~-0.9~~ -1.0	-1.1
Extend, but do not increase VA loan fees for housing programs	-0.2	-0.2
Postal Service/DC pay (Chiles 2 percent plus 2 years plan option--half employee health)	-0.1	-0.5
Others		
Federal pay -2% cap, retain 3 month delay	---	-2.7
*****	-3.8	-11.8
TOTAL ENTITLEMENTS SAVINGS	-9.3	-24.7

11/2/87

Howard –

Tomorrow I address luncheon at Brookings (annual) seminar on Postal Service. I plan to suggest more competition for P.S. and at same time giving P.S. greater freedom to compete. Privatization theme. (I also cite, approvingly, legislation introduced by Phil Crane.)

Let me know if you have any problems with this. (I talked with Tom Griscom and will get a copy of the draft to him ASAP.)

DETAIL FOR ADMINSTRATION's FREEZE ALTERNATIVE
(in billions of dollars, by fiscal year)

11/05/87
3 percent

	1987 Actual	1988 G-R-H	1988 Sequester	1988 Proposal	1989 G-R-H	1989 Proposal	Deltas 88 Plan	Deltas 89 Plan
Revenues:								
Gov. receipts & user fees 1/	854.1	903.0	903.0	912.4	964.6	978.6	9.4	14.0
Asset sales/privatization....	0.0	0.0	0.0	5.0	0.0	5.0	5.0	5.0
Subtotal, revenues..........	854.1	903.0	903.0	917.4	964.6	983.6	14.4	19.0
Outlays:								
Entitlements.................	467.5	491.5	488.9	487.3	518.8	512.8	-4.2	-6.0
Discretionary:								
Defense:								
BA.........................	291.0	302.7	278.8	291.0	314.6	299.7	-11.7	-14.9
Outlays....................	286.9	289.7	278.2	283.4	301.0	294.0	-6.3	-7.0
International Affairs:								
BA.........................	17.1	17.9	16.4	17.1	18.6	17.7	-0.8	-0.9
Outlays....................	16.6	16.9	16.1	16.2	17.6	16.7	-0.7	-0.9
Non-defense:								
BA.........................	142.7	149.7	137.0	142.7	155.6	146.9	-7.0	-8.7
Outlays....................	144.4	168.5	161.1	164.1	175.0	169.0	-4.4	-6.0
Net interest...............	138.5	145.9	145.0	144.7	152.3	155.9	-1.2	-3.6
Gross outlays..............	1053.9	1112.5	1089.3	1095.7	1164.7	1148.4	-16.8	-23.5
Undist. offsetting receipts and other..................	-51.8	-46.5	-46.5	-46.5	-46.5	-46.5	0.0	0.0
Total, net outlays..........	1002.1	1066.0	1042.8	1049.2	1118.2	1101.9	-16.8	-23.5
Deficit.....................	148.0	163.0	139.8	136.8	153.6	118.3	-31.2	-42.5

1/ Includes new user fees. Existing user fees are shown in the outlay base.

2/ If the defense mismatch were corrected in the G-R-H baseline, total outlays would increase by $5.0 billion in 1988 and $6.3 billion in 1989.

PROPOSAL

(1) FY 1987 outlays were $1,002 billion. Unless we act, outlays will grow at by over six percent in FY 1988 and by nearly an additional five percent in FY 1989. The progress we have made on the deficit is at risk.

(2) We would restrain all appropriated accounts to the levels they received last year. This is a fair and equitable freeze. The Appropriations Committees would be allowed to follow their normal processes (e.g., transfers, reprogrammings, etc.) to shift resources to higher priorities within the freeze total.

(3) Outlays on entitlement programs are projected to grow from 467.5 to FY 1987 to 491.5 to 1988. We would restrain this growth by $4.2 billion. The ideas from Senators Chiles and Domenici would be more than adequate for this purpose. Social Security would remain off the table.

(4) The enforcement procedures proposed by Senator Domenici would be used to assure savings are actually realized.

(6) The Conference would instruct the Administration and Congressional technicians to agree on common scoring procedures. Any remaining differences would be averaged.

11/06/87

ADMINISTRATION'S DEFICIT REDUCTION ALTERNATIVE
(savings from G-R-H baseline, in billions of dollars)

Item	FY 1988	FY 1989
Revenue increases:		
Receipts (R_1)	8.0	12.0
User fees (R_2)	1.4	2.0
Asset sales (R_3)[1]	5.0	5.0
Subtotal, revenues...........	14.4	19.0
Outlay reductions:		
Discretionary programs:[2]		
Defense (050)[3]	3.5	6.0
International (150)..........	0.4	0.8
Domestic.....................	2.4	5.2
Subtotal, discretionary..	6.3	12.0
Entitlement programs[4]	4.2	6.0
Subtotal, outlays............	10.5	18.0
Debt service..........................	1.0	3.3
Total deficit reduction...........	25.9	40.3

1. Includes "fix" of VA loan problem.
2. "Soft" freeze for FY 1988 and 2.0 percent increase for FY 1989.
3. BA of 291 for FY 1988 and 301 for FY 1989.
4. Average of Chiles/Gray (3.7) and Domenici-as-amended-by-Packwood (4.7) entitlement plans.

11/06/87

ADMINISTRATION'S DISCRETIONARY FREEZE ALTERNATIVE
(savings from G-R-H baseline, in billions of dollars)

Item	FY 1988	FY 1989
Revenue increases:		
Receipts (R_1)	8.0	12.0
User fees (R_2)	1.4	2.0
Asset sales (R_3)[1]	5.0	5.0
Subtotal, revenues	14.4	19.0
Outlay reductions:		
Discretionary programs:		
Defense (050)	6.3	7.0
International (150)	0.7	0.9
Domestic	4.4	6.0
Subtotal, discretionary	11.4	13.9
Entitlement programs[3]	4.2	6.0
Subtotal, outlays	15.6	19.9
Debt service	1.2	3.6
Total deficit reduction	31.2	42.5

1. Includes "fix" of VA loan problem.
2. Freeze in discretionary spending for FY 1988; and 3.0 percent increase for FY 1989.
3. Average of Chiles/Gray (3.7) and Domenici-as-amended-by-Packwood (4.7) entitlement plans.

Budget Thoughts:

1) take the 2 percent solution

with these conditions:

1) recission authority for remainder this term and two-years into next term

2) commitment to vote this year in both House and Senate (House going first) on his consitutional amendment to balance the budget

3) a dedicated tax that goes to reduce the deficit (such as to pay off interest costs) that remains in effect until deficit reaches $50 billion and then automatically expires and cannot be extended

4) commitment that in no one year can the rate of decrease in spending be greater in one year when compared to other areas

This should be considered to be put on table today by the President when Domenici and Co. come in demanding a two percent solution. To give the President the cover he needs in both the entitlement and tax area, these conditions should be accepted by at least our Republicans.

THE WHITE HOUSE
WASHINGTON

November 5, 1987

Will Ball called with the following:

Senator Dole wants a meeting this evening with the President and the GOP negotiators to the budget deficit talks -- Dole says that their negotiations just concluded and accomplished nothing and the appearance of some action is essential.

DEFENSE BUDGET DISCUSSIONS

FY 88		FY 89 at 0% R.G.	FY 89 at 3% R.G.
BA	291	301.6	310.6
O/L	289.2	294.0	297.2
R.G. p.a. from 81		2.6	3.0%
R.G. p.a. from 85		-2.8	-2.1%

While significant reductions to many critical DoD programs will be necessary if FY89 funding is cut to $311 billion and grows at a real 3% thereafter, we may be able to avoid significant cuts in the size of our conventional forces and protect key strategic programs such as the Small ICBM and the Strategic Defense Initiative. If funding is cut to $302 billion and real growth is held at 0 to 1% thereafter, reductions in general purpose force structure and strategic programs will probably occur. Either the small ICBM would have to be cancelled and other strategic programs slowed or SDI would have to be delayed significantly. By the mid-1990s, general purpose forces could be as much as 10% smaller in major categories, e.g., 16 vice 18 Army divisions, 550 vice 610 Navy ships, and 34 vice 38 tactical air wings. These cuts, combined with minor reductions in operating tempo and sustainability needed to get to the $311 billion level, would probably lead to curtailment of our overseas commitments, at a time when actual and/or prosepctive reductions to the nuclear elements of our overall deterrent posture are worrying our allies around the world.

As of 1710, Nov 4, 87