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THE WHITE HOUSE

WASHINGTON

January 24, 1985

MEMORANDUM FOR RICHARD G. DARMAN
ASSISTANT TO THE PRESIDENT AND
DEPUTY TO THE CHIEF OF STAFF

FROM: JOHN G. ROBERTS 
ASSOCIATE COUNSEL TO THE PRESIDENT

SUBJECT: Part III: Economic Assumptions
and the Budget (prepared by OMB)

Counsel's office has reviewed the above-referenced paper
and has no objection to it from a legal perspective.

bcc: Dianna Holland

WHITE HOUSE STAFFING MEMORANDUM

DATE: 1/24/85 ACTION/CONCURRENCE/COMMENT DUE BY: 1:00 p.m. 1/25/85

SUBJECT: PART III: ECONOMIC ASSUMPTIONS AND THE BUDGET
 (prepared by OMB)

	ACTION FYI			ACTION FYI	
VICE PRESIDENT	<input type="checkbox"/>	<input type="checkbox"/>	MURPHY	<input type="checkbox"/>	<input type="checkbox"/>
MEESE	<input type="checkbox"/>	<input checked="" type="checkbox"/>	OGLESBY	<input checked="" type="checkbox"/>	<input type="checkbox"/>
BAKER	<input type="checkbox"/>	<input checked="" type="checkbox"/>	ROGERS	<input type="checkbox"/>	<input type="checkbox"/>
DEAVER	<input type="checkbox"/>	<input checked="" type="checkbox"/>	SPEAKES	<input type="checkbox"/>	<input type="checkbox"/>
STOCKMAN	<input type="checkbox"/>	<input type="checkbox"/>	SVAHN	<input checked="" type="checkbox"/>	<input type="checkbox"/>
DARMAN	<input type="checkbox"/> P	<input checked="" type="checkbox"/> SS	VERSTANDIG	<input checked="" type="checkbox"/>	<input type="checkbox"/>
FIELDING	<input checked="" type="checkbox"/>	<input type="checkbox"/>	WHITTLESEY	<input checked="" type="checkbox"/>	<input type="checkbox"/>
FULLER	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<u>NISKANEN</u>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HERRINGTON	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
HICKEY	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
McFARLANE	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
McMANUS	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>

REMARKS:

May we have your comments no later than 1:00 p.m. tomorrow. Thank you.

RESPONSE:

Richard G. Darman
 Assistant to the President
 Ext. 2702

PART 3

ECONOMIC ASSUMPTIONS
AND THE BUDGET

ECONOMIC ASSUMPTIONS AND THE BUDGET

This part of the budget discusses the economic assumptions underlying the 1986 budget estimates. The first section reviews the recovery that has returned the economy to healthy growth with moderate inflation, following many years of stagflation. The second section presents the near-term forecast for 1985-86 and the long-term economic assumptions that underpin the budget projections through 1990. The third section discusses the relationship between Federal debt and capital formation. The fourth section describes the sensitivity of the budget to changes in economic assumptions. The last section describes how economic developments and changes in the economic forecast have modified the budget outlook since last year.

THE ECONOMIC OUTLOOK: THE RECOVERY CONTINUES

When the administration took office in 1981, inflation was out of control. The rapid increase in prices was hurting economic growth, investment was being diverted into unproductive inflation hedges, and normal business and household planning were being hindered by the uncertainty surrounding the outlook for prices and costs. Labor productivity in the economy's nonfarm business sector grew at an annual rate of 2.0% between 1948 and 1981, but by only 0.5% from 1973 to 1981. The collapse of productivity growth during the 1970's produced stagnating real wages even while nominal wage rates were rising rapidly.

Under the circumstances, controlling inflation had to be the administration's top priority. In 1980, inflation was running about 12-1/2%; in the last 2 years, it has been cut to only 4%. This dramatic reduction helped convince American families and businesses that they could plan for the future once again without fearing that unpredictable price increases would make their plans futile.

The lower rate of inflation, together with the administration's program to restore incentives for work, saving and investment by lowering tax rates and reducing the regulatory burden on business, led to the robust economic recovery of the past 2 years. The recovery has fostered a new sense of confidence in America's economic future as it offers the prospect of sustained economic growth with low and stable inflation for the first time in many years.

An Overview of the Recovery.—The recovery from the 1981-82 recession began in late 1982. It was sparked by a shift in monetary and fiscal policy that contributed to a surge of growth in the money supply, a dramatic decline in interest rates, and a strong rally in the stock market.

The boom in the stock market was part of a broader shift in the public's asset preferences. For most of the previous decade, savers who had invested in financial assets had been losers to a combination of inflation and taxes. Inflation drove interest rates up and bond prices down, while eroding the real value of interest income and dividend payments. Compounding the injury, taxes were levied on the nominal income on these financial assets, "income" that often was inadequate even to preserve the assets' value.

Similar problems were reducing business profitability. Depreciation allowances based on the historical cost of fixed capital understated true depreciation in a time of rapidly rising capital costs. Conventional accounting practices also overstated inventory profits when inflation was raising the true replacement cost of goods sold. A growing burden of Federal regulation raised production costs, while limiting investment opportunities. The result of these trends was a decline in profitability that was reflected in the weak performance of corporate equities throughout the period. Stock prices, even accounting for dividends, failed to keep up with inflation in the 1970's.

It is not surprising that, by the end of the decade, investors were searching for ways to shelter their wealth from the ravages of inflation and the taxation of fictitious profits. The fact that these "investments" were often unproductive hedges such as gold or commodities spread the debilitating effects of the inflation from the financial markets to the real economy. Therefore, the stock market rally of the summer of 1982 was a significant event. It signaled the beginning of a shift back from investment in unproductive inflation hedges and commodity speculation to investment in productive capital assets.

The rally also marked a reevaluation by investors of the long-run profitability of American business. That reevaluation was justified as profits climbed in the first 2 years of the upturn at a steeper pace than during any other postwar recovery. The greatly improved earnings were achieved even as inflation declined, in large part because a recovery in productivity growth and moderate wage increases held down unit costs and boosted profit margins.

The economy's recovery in 1983 was widely expected by forecasters, but they were surprised by the magnitude of the rebound. From the fourth quarter of 1982, the trough of the recession, to the fourth quarter of 1983, real GNP grew 6.3%; this was a faster rate of growth than in all but 5 other years in the postwar period. Most

ECONOMIC ASSUMPTIONS AND THE BUDGET

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UNIT PRICES, COSTS, AND PROFITS: NONFINANCIAL CORPORATE BUSINESS

(Percent change, annual %1e)

	Unit prices ¹	Unit costs ²	Profit margins ³	Total profits ⁴
Recession:				
1981:3-1982:4	4.1	6.8	-24.9	-28.1
First two years of expansion:				
1982:4-1984:4	3.1	0.4	39.7	50.8
Average postwar expansion ⁵	2.4	1.1	13.6	22.9

¹ The implicit price deflator for gross domestic product of nonfinancial corporate business.² Labor and interest charges plus non-factor costs (e.g., depreciation) divided by real output of nonfinancial corporate sector.³ Pre-tax profits (with inventory valuation and capital consumption adjustments) of nonfinancial corporate business divided by output in 1972 dollars.⁴ Pre-tax profits (with inventory valuation and capital consumption adjustments) of nonfinancial corporate business.⁵ Excluding 1949 and 1980 expansion.

forecasters expected strong economic growth in 1984, and this time they were correct: real GNP grew 5.3% (according to preliminary figures from the Commerce Department). The 2-year average growth rate of 5.8% was as strong as the recovery from any recession since 1950.

The last 2 years have also seen a rapid drop in unemployment. In the 25 months from November 1982 to December 1984, the civilian unemployment rate fell 3.5 percentage points, a larger decline than in any recovery since 1950. It is also noteworthy that the unemployment rate is now slightly lower than it was at the peak of the last business cycle in July 1981. In every other recovery since 1950, the unemployment rate at this point in the expansion was still considerably above its level at the previous peak.

Consumer spending usually leads the recovery, and the current upturn is no exception. During recessions, consumers tend to postpone purchases of housing and other "big-ticket" items like cars and home appliances. An increase in consumer net worth and declining interest rates, the result of easier monetary conditions, releases this pent-up demand and helps spur the recovery. From the third quarter of 1982 through the first quarter of 1983, the increase in real personal consumption expenditures outpaced the increase in real GNP.

The recovery is also usually strengthened by the decisions of business firms to restock inventories depleted during the recession. In the initial year of the current recovery, real inventory investment rose a hefty \$32 billion and accounted for about a third of the real GNP gain.

As the recovery proceeded, however, it developed features that were either not expected when it started, or which broke with previous business cycle experience. Most noteworthy have been the moderate inflation rate, the boom in capital spending, the dollar's strength in the foreign exchange markets with the associated

inflow of capital from abroad, and high real interest rates. These features are reviewed in the following sections.

The Moderate Pace of Inflation.—The low inflation rate continues to surprise observers. Since the beginning of the long process of disinflation in 1981, most forecasters have persistently overestimated prospective price increases. At the beginning of 1984, there were widespread expectations that inflation would accelerate somewhat before the end of the year. In the fourth quarter, however, the GNP deflator rose at an annual rate of less than 3%. For the year as a whole, on a fourth quarter over fourth quarter basis, the deflator rose 3.7%, the same rate as it has maintained since the trough of the recession.

Although inflation was often stable or declining during the early phases of previous postwar expansions, recent inflation is noteworthy for two reasons:

- The average inflation rate, 3.7%, is lower than in four of the seven previous recoveries since World War II. This reverses a pattern evident since the early 1960's in which the inflation rate was higher in each successive cyclical upturn.
- Given the substantial decline in inflation that occurred in 1982, many market forecasters expected disinflation to run its course earlier in this recovery than in the immediately preceding cycles. Although inflation has not declined significantly since the trough of the recession, it has not risen, either.

Steady moderate inflation over the long run requires a disciplined policy of moderate growth of the money supply by the Federal Reserve. In the early 1980's, many questioned whether the Federal Reserve could persevere in such a policy. Last year, however, it succeeded in holding money supply growth within the lower portion of its 4%-8% target band for M1, while the broader aggregates grew near the upper bounds of their target ranges. The preliminary targets for this year, announced by the Federal Reserve in July, are 4%-7% for M1, slightly lower and narrower than the 1984 range.

In the short run, special factors can alter the rate of inflation. During the present recovery, the most significant special factor helping to lower inflation has surely been the extraordinary rise in the exchange value of the dollar. In 1984, the dollar appreciated by 12%. This continued a trend that has pushed the dollar's value up by 70% since the fall of 1980.

When the dollar appreciates, the prices of imported goods are reduced, and the prices of competing domestic goods are also reduced, with a lag. It is estimated that the dollar's appreciation has reduced the inflation rate by roughly one to two percentage points annually for the past 4 years. Since the full adjustment process takes up to 3 years, the dollar's appreciation in 1984 will continue

to put downward pressure on prices in 1985 and 1986 if the dollar remains near its current level.

The dollar's rise in 1984 was also related to 2 other developments that helped to reduce inflation last year.

- Agricultural and other commodity prices declined in the second half of 1984, after rising sharply in the early stages of the recovery. Since many commodities are imported, their prices were cut by the rise of the dollar.
- Oil prices continued to edge downward as stagnant demand for oil produced excess supply on world markets. The average price of imported oil has fallen by \$2.60 a barrel since January 1983, and prices are expected to fall further in 1985.

The price of oil is quoted in dollars so a change in the exchange value of the dollar does not affect the price of oil directly, but it does have important indirect effects. Since the oil price is quoted in dollars, foreigners must pay more for oil in terms of their own currencies when the dollar rises, as it did last year. This increase in the foreign price of oil strengthened the trend already underway toward reduced world oil demand, and indirectly helped put downward pressure on the dollar price of petroleum.

Although the strong dollar was a major contributor to the disinflation that has occurred since the peak of the last business cycle, the moderation of inflation has proceeded far beyond what can be traced directly to the strong dollar or to softening commodity prices. Deregulation and a resurgence of entrepreneurial vigor—spurred on, to be sure, by the inroads of foreign producers in U.S. markets—have contributed to a highly competitive atmosphere. Lower inflation expectations, engendered by the success in reducing inflation and the administration's commitment to continuing that policy, have also contributed to the process. Together, these forces have produced a marked reduction in inflation across the entire economy, extending far beyond the goods traded in international commerce. One indication of this broad-based trend is the fact that wage inflation has slowed down about as much in non-manufacturing industries as in the manufacturing sector.

The progress against inflation since 1981 has been remarkable, but it would be premature to declare a final victory against inflation. After all, a 4% rate of inflation doubles prices in 18 years and that is a far cry from price stability. Moreover, the special factors that have helped to pull inflation down during the past few years may end or even reverse themselves in the future. Had the dollar not been increasing so rapidly, inflation would have proceeded at a 5 to 5-1/2% rate last year. The dollar cannot continue to rise indefinitely. The relative price of oil should also stabilize eventually. When this happens, there could be some acceleration of inflation. Most importantly, inflation will not stay down unless the

Federal Reserve continues the policy of restrained growth of the money supply that was so important in reducing the rate of inflation in the first place. Continued restraint can serve to prevent any unfavorable shocks that do occur in the future from initiating a new cycle of rising inflation. A moderate rate of inflation gradually trending toward price stability provides the necessary background for healthy economic growth. One of the keys to the strong growth that has marked the present recovery has been the fundamental change in the inflation outlook since 1981. To maintain this success, policies of feverish demand expansion must be avoided. A commitment to steady monetary policy can sustain reasonably stable and moderate inflation indefinitely.

The Boom in Business Fixed Investment.—The increase in capital spending in the present expansion is far stronger than normal. Over the past 2 years, real gross nonresidential fixed investment increased at a 14.9% annual rate, compared with an average increase of less than 7% in previous cycles between 1950 and 1980.

Part of this investment boom simply reflects the severity of the 1981-82 recession. Investment is always depressed during business downturns, and the deeper the recession, the farther investment has to recover in order to reach a normal level. However, even after adjusting for the effect of the recession by measuring the change in investment from the peak rather than the trough of the cycle, the increase in capital spending remains impressive. Since the July 1981 peak, real business fixed investment has grown at an average yearly rate of 5.7%, more than three times faster than the average gain over comparable stages of previous cycles.

There is a strong statistical relationship between the level of business fixed investment and the change in business sales. This is usually explained by business's desire to maintain a stable capital-output ratio. If output rises, then so will the desired stock of capital, and that leads to an increase in investment. This accelerator mechanism is clearly at work in the present expansion. The normal response to a healthy increase in sales like that experienced in the past 2 years would be a boom in investment spending. However, the growth in investment spending in the past 2 years has been too large to be explained entirely by this factor. Other forces were also at work:

- The administration's tax cuts significantly raised depreciation allowances for many investments, reducing the real cost of capital to business firms for a broad range of investments.
- High inflation raised the effective rate of business taxation in the 1970's. Since 1980, the marked decline in inflation has lowered effective business tax rates, and would have done so even in the absence of more favorable depreciation allowances.

- Prices of investment goods have been very stable in the current expansion, reflecting, in part, the strong dollar and the heightened competition from foreign producers of capital goods. The price deflator for nonresidential fixed investment was slightly lower at the end of 1984 than it was 2 years earlier.
- Low and stable inflation has also removed much of the uncertainty that was hampering investment prior to the present recovery.
- The strong recovery, moderate wage demands, and a productivity rebound resulted in a sharp 55% annual rate of increase in corporate profits during the expansion's first 6 quarters. Healthy profits, whether as a signal of future profitability or because internally generated funds are cheaper than external funds, are usually associated with an increase in investment.

The strength of business-fixed investment has been concentrated in expenditures for producers' durable equipment; investment in nonresidential structures has experienced only a typical cyclical upturn. The difference in the two components reflects, in part, the relatively favorable tax treatment that equipment receives under the current tax code.

The increase in capital spending has raised net investment as well as gross investment, but not to the same extent. It is net investment that determines the rate of growth of the capital stock and helps to determine future economic growth, a fact that the administration has taken into account in its economic assumptions. The discrepancy between the two measures is accounted for by the shifting composition of investment. The trend toward short-lived assets that depreciate more rapidly has raised the share of capital replacement in total gross investment.

The Dollar and the Net Inflow of Foreign Capital.—The increased profitability of U.S. investment opportunities as a result of tax changes, rapid expansion, low inflation and deregulation has attracted a record net inflow of foreign capital. The strong international demand for U.S. assets led to a rise of 70% in the multilateral trade-weighted value of the dollar since the third quarter of 1980.

The strength of the dollar has helped reduce inflation and has benefited consumers. However, the counterpart of the dollar's rise and the capital inflow has been a worsening of the U.S. current account. The current account, the broadest measure of trade, services and interest payments between the U.S. and other countries, shifted from a nearly balanced position in 1980, to a deficit amounting to 3% of GNP by the second half of 1984. A higher dollar has made U.S. exports more expensive for foreigners, and

imported goods cheaper at home. This has encouraged a surge of imports, while producing sluggish growth in the export and import-competing sectors of the economy. The effect of the high exchange rate has been compounded by the sluggish growth of the major European economies and the weak import demand and aggressive export promotion of many heavily indebted less-developed countries.

During the 1950's and 1960's, the U.S. enjoyed persistent current account surpluses which were used to finance capital investment overseas. U.S. assets abroad exceeded foreign assets in the U.S. by \$150 billion at the end of 1982. However, during 1983, the surplus of assets eroded to \$106 billion, and will erode further in 1984. Sometime this year, recorded foreign assets in the U.S. will exceed our assets abroad, making us a net debtor nation. In fact, the shift has probably already occurred, but it is obscured by a persistent large discrepancy in the U.S. international accounts. The discrepancy is believed, in large part, to represent unrecorded net capital inflows into the U.S.

The continued inflow of capital has reduced the surplus on investment income which the U.S. has enjoyed over the past decade by increasing interest payments to foreigners. In 1980, the U.S. surplus on nontrade items amounted to \$26 billion; it eroded to \$10 billion in 1984. Given the prospect of large current account deficits for the foreseeable future, the U.S. will soon be making a net transfer of investment income to foreigners.

In the 1970's, the U.S. was able to run a large trade deficit while maintaining a balanced current account since it received substantial net investment income from foreigners. In the future, we will not be able to pay for a substantial quantity of imported goods with the proceeds from our foreign investments. Instead, we will have to export in order to pay interest on our foreign borrowing.

The expansion has been stronger in the aggregate than is typically the case. Therefore, it is hard to argue that the high dollar and the capital inflow have been detrimental to overall growth thus far. The effects have been mainly compositional, with exporting and import-competing industries adversely affected, while the benefits have been spread more diffusely throughout the economy. The long-run problems concern the consequences for the economy should foreigners attempt to reduce their purchases of dollar assets while we are still running a large current account deficit. Under such circumstances, the inflation rate might temporarily rise as the dollar's exchange rate falls. In addition, there could be a rise in interest rates and slower overall economic growth.

High Real Interest Rates.—The real interest rate is the difference between the prevailing market rate of interest and the expected rate of inflation. These terms are somewhat imprecise, and the

expected rate of inflation is not even observable. Nonetheless, the influence of real interest rates on economic activity is pervasive. It is the real interest rate that measures the true cost of borrowing and the true return to saving. By contrast, the nominal interest rate may convey little significant information about the cost of capital. Nominal rates of 10% can be either excruciatingly high or ridiculously cheap, depending on how fast inflation is eroding the value of money.

Since 1980, the inflation rate and inflation expectations have declined substantially. Market interest rates have also fallen, but by no more than the decline in inflation expectations. Consequently, real interest rates appear to have remained on a rough plateau far above their historical values. As described above, capital spending boomed in spite of the apparently high interest rates. The administration's business tax cuts, lower inflation and the fall in the relative price of capital goods offset the high real rates. Indeed, some have suggested that the improved investment outlook is responsible for keeping real rates high by stimulating borrowing.

While strong business investment demand for savings has undoubtedly contributed to keeping rates high, so has heavy Government borrowing. It would be wrong to attribute all of the increase in real rates to only one component of the demand for savings. It is the combined demands of Government and business that have kept real rates high. The decline in the deficit that would result from enacting this budget should remove some of the strain on interest rates, and permit the high long-term real rate to return gradually to its historical norm.

ECONOMIC ASSUMPTIONS

This section describes the economic assumptions that underlie the estimates in the budget. The current services estimates displayed in the budget are based on these same economic assumptions. Permitting the budget to proceed on a current services basis—that is, with no future policy action to change program spending or receipts—would change significantly, and for the worse, the economic performance from what is assumed for the budget. However, the convention of basing both the budget estimates and the current services estimates on a common set of economic assumptions limits the differences between them to the direct effects of proposed policy actions. This permits the current services estimates to serve their purpose as a baseline against which to measure the budgetary effect of policy proposals. In keeping with the usual practice, the assumptions are presented for calendar years, rather than fiscal years.

The short-term forecast for 1985-86 is based on an assessment of the implications of recent developments for the economic outlook.

Consequently, this section begins with a brief review of those developments. It is followed by a discussion of the short-range outlook, accompanied by a table that presents the forecast through 1986. The section concludes with a discussion of the administration's long-range economic assumptions for the 1987-1990 period, accompanied by a table in which these assumptions are presented in detail.

Shifting Gears: The Pause of 1984.—Economic activity grew at a rapid 8-1/2% annual rate in the first half of 1984. This continued the trend evident in the second half of 1983 and helped to make the recovery as strong as any previous postwar expansion. However, in the second half of 1984, economic growth slowed abruptly to only a 2% rate.

The growth of consumer spending lost momentum in the summer months after a buying spree in the spring: real consumption expenditures, which grew at about an 8% annual rate in the second quarter, were essentially flat from July to September. The lull in spending was unexpected and resulted in a build-up of unwanted inventories during the third quarter. Subsequently, excess inventories were reduced through a modest curtailment of production. As the economy entered the new year, industrial production was again on the rise, signalling an end to the pause.

COMPONENTS OF REAL GNP

(Percent change, annual rate)

	1983 ¹	1984			
		Q1	Q2	Q3	Q4
Real GNP	6.3	10.1	7.1	1.6	2.8
Final sales	4.1	3.6	10.3	-1.0	5.6
Change in business inventories ²	-3.6	31.6	20.3	30.6	20.0

¹ Fourth quarter of 1982 to fourth quarter of 1983.

² Dollar amount in billions of 1972 dollars.

The kind of economic growth the economy experienced in the first half of 1984 is not sustainable on a long-term basis, but it is typical of the early stages of a business cycle expansion. It is also typical for the economy to pause following such periods of rapid growth in order to digest earlier gains. In four previous postwar expansions, a pause occurred after six to eight quarters of rapid growth (see chart). The previous pauses lasted two to three quarters during which growth was below its long-term trend, but not negative. The pauses were followed by renewed economic growth. If economic growth picks up again early this year, as assumed here and as predicted by most private forecasters, the recent pause will be in line with historical experience.

[Insert chart: REAL GNP GROWTH]

Financial indicators suggest that economic activity will shift to a higher gear shortly. The Federal Reserve has moved aggressively in recent months to increase the growth of the money supply. The money supply, which fell slightly from June to October, rose at a 10% annual rate in November and December. Short-term interest rates, notably, the Federal funds rate and the 91-day Treasury bill rate, fell over 2-1/2 percentage points from the beginning of September to the end of December. The discount rate was lowered 1 percentage point in two stages in November and December. This shift in monetary policy should help to quicken the pace of economic growth in 1985.

Already there are signs of a return to more rapid growth. Final sales in real terms rose at a 5-1/2% annual rate in the fourth quarter, after declining in the third. The strong 1.3% rise in the index of leading indicators in November, following 5 months in which the index fell 2.4%, is another signal that the pause in economic growth is nearing its end. Moreover, the 4.3% rise in new durable goods orders in November suggests that investment will continue to show strength in 1985.

The Outlook for 1985-86.—Although economic growth has revived following previous pauses, it has never resumed the torrid pace set

in the recovery phase of expansions. It is relatively easy to increase output during the initial recovery phase. Ample supplies of unemployed labor and unused capacity are available to meet any surge in demand. However, much of the unused supply is absorbed in the initial stage of the recovery, and subsequent growth depends on the economy's ability to add to its supplies of labor and capital. It is then that the economy's supply-side becomes the dominant factor determining the rate of growth.

In the early stage of a cyclical recovery, any underestimate of aggregate demand is likely to produce an underestimate of real economic growth. This was the error forecasters made in 1983. However, as the recovery proceeds, an underestimate of demand is more likely to produce a mistakenly low estimate for the rate of inflation. This was the common mistake in the late 1970's.

The forecast for 1985-86 assumes that monetary policy will avoid excessive stimulus, while providing sufficient liquidity to sustain the expansion. It is wrong to assume that, because a stimulative monetary policy can produce a rapid rate of real economic growth in the early stages of a business cycle recovery, it is capable of producing rapid growth at any stage of the cycle. Experience suggests that attempts to do that result in accelerating inflation and a premature end to what might otherwise be a long and healthy expansion.

The highlights of the forecast include the following:

- Real GNP is expected to grow 4% in both 1985 and 1986. This is consistent with a return to healthy expansion following a temporary pause.
- The GNP deflator is expected to rise 4.3% in both 1985 and 1986. This is a slight acceleration from its remarkably low rate of increase in 1984, but it is still a moderate and predictable pace.
- The unemployment rate is expected to decline modestly in 1985 and 1986.
- The downward trend in interest rates in the second half of last year is not expected to be reversed. Both long-term and short-term interest rates are projected to decline somewhat over the 2-year forecast horizon, but long-term rates are expected to fall more than short-term rates.

The Long-Run Assumptions: 1987-1990.—The long-term economic assumptions are not intended to be a precise forecast of future economic conditions. They are projections of trends for the relevant economic variables. The projections are based on the presumption that the fiscal policy presented in this budget will be enacted, and that the Federal Reserve will continue to pursue a policy of reducing the growth of the monetary aggregates.

ECONOMIC ASSUMPTIONS AND THE BUDGET

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SHORT-RANGE ECONOMIC FORECAST

(Calendar years, dollar amounts in billions)

Item	Actual 1983	Forecast		
		1984	1985	1986
Major economic indicators:				
Gross national product, percent change, fourth quarter over fourth quarter:				
Current dollars.....	10.4	9.2	8.5	8.5
Constant (1972) dollars.....	6.3	5.3	4.0	4.0
GNP deflator (percent change, fourth quarter over fourth quarter).....	3.8	3.7	4.3	4.3
Consumer Price Index (percent change, fourth quarter over fourth quarter) ²	2.9	3.6	4.2	4.3
Unemployment rate (percent, fourth quarter) ³	8.4	7.1	6.9	6.8
Annual economic assumptions:				
Gross national product:				
Current dollars:				
Amount.....	3,305	3,660	3,942	4,278
Percent change, year over year.....	7.7	10.7	7.7	8.5
Constant (1972) dollars:				
Amount.....	1,535	1,638	1,698	1,766
Percent change, year over year.....	3.7	6.7	3.7	4.0
Incomes:				
Personal income.....	2,744	3,012	3,236	3,478
Wages and salaries.....	1,559	1,803	1,921	2,066
Corporate profits.....	203	235	242	286
Price level:				
GNP deflator:				
Level (1972 = 100), annual average.....	215.3	223.4	232.2	242.3
Percent change, year over year.....	3.8	3.8	3.9	4.3
Consumer Price Index: ²				
Level (1967 = 100), annual average.....	297.4	307.6	320.2	334.2
Percent change, year over year.....	3.0	3.4	4.1	4.3
Unemployment rates:				
Total, annual average ³	9.5	7.4	7.0	6.9
Insured, annual average ⁴	3.8	2.8	2.8	2.8
Federal pay raise, January (percent): ⁵				
Military.....		4.0	4.0	5.2
Civilian.....		4.0	3.5	-5.0
Interest rate, 91-day Treasury bills (percent) ⁶	8.6	9.6	8.1	7.9
Interest rate, 10-year Treasury notes (percent).....	11.1	12.4	11.0	10.3

¹ Preliminary actual data.² CPI for urban wage earners and clerical workers. Two versions of the CPI are now published. The index shown here is that currently used, as required by law, in calculating automatic cost-of-living increases for indexed federal programs. The manner in which this index measures housing costs changed significantly in January.³ Percent of total labor force, including armed forces residing in the U.S.⁴ This indicator measures unemployment under State regular unemployment insurance as a percentage of covered employment under that program. It does not include recipients of extended benefits under that program.⁵ A 3.0% military pay raise is projected for July 1985. The 1986 military pay raise is projected for October.⁶ Average rate on new issues within period, on a bank discount basis. These projections assume, by convention, that interest rates decline with the rate of inflation. They do not represent a forecast of interest rates.

Real GNP is projected to grow at an annual rate of 4% in 1987 and 1988. Over the next 2 years, its projected growth rate slows down to 3.6%, close to its long-run average. This is consistent with a gradual decline in the total unemployment rate to 5.8% by 1990. Underlying the projected growth rate are assumptions that a strong increase in employment will occur and that output per hour

LONG-RANGE ECONOMIC ASSUMPTIONS

(Calendar years; dollar amounts in billions)

	Assumptions			
	1987	1988	1989	1990
Major economic indicators:				
Gross national product, percent change, fourth quarter over fourth quarter:				
Current dollars	3.3	7.9	7.4	6.9
Constant (1972) dollars	4.0	4.0	3.7	3.6
GNP deflator (percent change, fourth quarter over fourth quarter)	4.1	3.8	3.5	3.2
Consumer Price Index (percent change, fourth quarter over fourth quarter) ¹	4.1	3.8	3.5	3.2
Unemployment rate (percent, fourth quarter) ²	5.5	6.2	6.0	5.7
Annual economic assumptions:				
Gross national product:				
Current dollars:				
Amount	4,535	5,009	5,391	5,772
Percent change, year over year	3.3	8.1	7.6	7.1
Constant (1972) dollars:				
Amount	1,336	1,910	1,984	2,056
Percent change, year over year	4.0	4.0	3.9	3.6
Incomes:				
Personal income	3,741	4,013	4,305	4,590
Wages and salaries	2,241	2,434	2,539	2,642
Corporate profits	335	360	376	395
Price level:				
GNP deflator:				
Level (1972 = 100), annual average	252.4	262.3	271.8	280.8
Percent change, year over year	4.2	3.9	3.6	3.3
Consumer Price Index: ¹				
Level (1967 = 100), annual average	348.1	361.7	374.8	387.2
Percent change, year over year	4.2	3.9	3.6	3.3
Unemployment rates:				
Total, annual average ²	5.6	6.3	6.1	5.8
Insured, annual average ³	2.6	2.5	2.3	2.2
Federal pay raise (percent):				
Military (October)	5.4	5.3	5.0	NA
Civilian (January)	3.0	3.0	3.0	3.0
Interest rate, 91-day Treasury bills (percent) ⁴	7.2	5.9	5.1	5.0
Interest rate, 10-year Treasury notes (percent)	9.3	7.3	5.7	5.5

¹ CPI for urban wage earners and clerical workers. Two versions of the CPI are now published. The index shown here is that currently used as required by law, in calculating automatic cost-of-living increases for indexed Federal programs.

² Percent of total labor force, including armed forces residing in the U.S.

³ This indicator measures unemployment under State regular unemployment insurance as a percentage of covered employment under that program. It does not include recipients of extended benefits under that program.

⁴ Average rate on new issues within period, on a bank discount basis. These projections assume, by convention, that interest rates decline with the rate of inflation. They do not represent a forecast of interest rates.

in the nonfarm business sector will grow at an average rate of about 2% over the 1985-1990 period.

Although the annual rate of growth in the population over 16 should be about 1% for the next 5 years, the economic assumptions call for an increase in employment substantially faster than that. There are three reasons for this assumption.

- The demographic and social trends that have already produced substantial increases in female labor force participation are expected to continue for the remainder of the decade.
- The number of people in the prime working ages of 25 to 54 will grow quite rapidly. This will raise the average rate of labor force participation for the total population.
- The total unemployment rate is assumed to decline gradually between now and 1990.

It is also assumed that a substantially faster growth of productivity than prevailed in the 1970's will be achieved. A variety of administration initiatives have helped foster a business climate that favors increases in efficiency.

- The most important factor justifying an optimistic productivity assumption is the strength in capital spending that has marked the recovery so far.
- Stable, moderate inflation has reduced uncertainty about future price increases, encouraging investment and long-term planning.
- Lower inflation expectations have helped moderate wage and salary demands, and more flexible work rules and fewer strikes have helped raise labor productivity.
- Deregulation of transportation, energy, and finance has increased productivity in these sectors and lowered their relative prices, transmitting the benefits of deregulation and raising productivity elsewhere.
- Prime-aged workers between 25 and 54 make up an increasing share of the total labor force, and their greater experience should raise average labor productivity.
- The prospect of stable or declining oil prices for the next several years is not only a boon to consumers, but should also eliminate one of the main causes of the sudden shocks that damaged productivity growth in the 1970's.
- The increase in research and development investment since the late 1970's has produced a stream of new innovations that will help to sustain productivity growth. Since 1978, the share of GNP going to research and development expenditures has increased 19%.
- Cost-cutting measures by businesses are likely to continue, spurred in part by foreign competition.

From the cyclical peak in the third quarter of 1981 to the fourth quarter of 1984, output per hour in the private nonfarm business sector increased at an annual rate of 2%. This period covers both the severe recession of 1981-82 and the two subsequent years of recovery. It is perhaps too soon to state conclusively that the poor productivity performance of the 1970's is over, but this sustained period of normal productivity growth certainly justifies a modest

degree of optimism that the economy will be able to maintain 2% productivity increases throughout the rest of the decade.

It is sometimes argued that the assumption that the economy will resume its average rate of productivity growth is too cautious. The claim is made that the economy can grow faster than 4% a year, that it is capable of 5% growth, or even more. After all, the economies of the Pacific Rim are growing at least this rapidly, and the U.S. grew nearly this fast for some of the time in the 1960's. Why not assume that the administration's policies will succeed in achieving at least comparable growth during the rest of the 1980's? It is, of course, impossible to prove that such rapid economic growth could not happen, but there are good reasons to believe it is highly unlikely.

- For 8 years following the trough of the 1960-61 recession, the economy grew at an average annual rate of 4.9%. This is the fastest the economy has grown in the postwar period for such an extended interval, comparable to the time that will have elapsed since the trough of the 1981-82 recession by the end of the forecast interval in 1990. In the 1960's, expansionary fiscal and monetary boosted the growth rate, but they also carried the economy past the threshold where it was possible for the rate of inflation to remain stable. When the spending boom began, the inflation rate was less than 2% a year; before the boom was over, it has nearly tripled. The virulent inflation unleashed by these irresponsible policies has only finally been brought under control during the last 4 years.
- The long-term economic assumptions already include an optimistic projection of labor productivity growth. If it is achieved, it will represent a major accomplishment following the dismal productivity performance of the 1970's. So far, the evidence suggests that productivity may be returning to the trend rate of increase assumed in the budget, namely, 2% a year. But 2 years into the recovery there is no hard evidence at all that it is approaching the much more rapid rates that would be required for real GNP to grow at 5% a year or faster.
- The recent investment boom is sometimes used to justify the belief that a rapid surge of productivity growth is just around the corner. However, net nonresidential fixed investment as a share of Net National Product, although growing rapidly, is only now returning to its postwar average following several years when it was below its normal level. It is net investment, rather than gross investment, that adds to the Nation's capital stock and contributes to productivity growth.

[Insert chart: NET INVESTMENT AS A SHARE OF

NET NATIONAL PRODUCT]

On the other hand, it has been argued that the assumption of 4% economic growth for the next few years is far too optimistic and that a more reasonable guess about future growth would be a rate of increase in real GNP of 3%, or even lower. However, this assumes in the years ahead that the economy will not be able to reach even its average level of performance in the earlier postwar period. Such caution would seem unduly pessimistic. The recovery that has occurred so far has been sparkling, and it is not unrealistic to hope that further improvement in the unemployment rate and a closer approach to normal capacity utilization are feasible. If economic growth over the next few years proceeds at no faster than 3%, then improvements in unemployment are likely to be very gradual.

An economic growth rate of 4% for the next several years is achievable with appropriate monetary and fiscal policies. Faster growth might be achieved, temporarily, by pursuing irresponsible policies to stimulate demand, but this kind of demand-led growth could not be sustained, and the attempt to do so would be highly inflationary.

The administration assumes that the rate of inflation, as measured by the GNP deflator, will increase slightly to 4.3% in 1986, and then decline gradually, falling to 3.2% in 1990. The administration remains committed to the policy of inflation reduction that has already produced significant results, and should continue to produce them in the future. This would be a unique accomplishment. The postwar era has not yet seen such a lengthy period of uninterrupted economic growth without an acceleration in the rate of inflation. The key to this policy is the Federal Reserve's commitment to a gradual and predictable reduction in the rate of growth in the money supply.

It is also assumed that real interest rates will gradually return to their long-term average levels by the end of the projection period.

DEFICITS, DEBT, AND CAPITAL FORMATION

Despite the relatively strong 4% growth trend and the declining interest rates incorporated in the assumptions, current services budget deficits remain in the \$220-\$240 billion range each year through 1990. Increases in the Federal debt of this magnitude can have important implications for the composition of private wealth and for capital formation.

From the end of World War II until 1980, Federal debt became a smaller and smaller share of total private wealth. This decline occurred even though the Federal budget was in deficit most of the years after World War II, and every year but one after 1960. The reason for this decline is that the deficits were small enough so that private saving and the revaluation of private wealth due to inflation added to private wealth faster than the deficits added to Federal debt. The recent large deficits, however, have caused a sharp increase in Federal debt that has reversed the post-World War II trend.

For the individual investor, Government securities and other forms of investment are basically similar. For the economy as a whole, however, there is a crucial difference. Except for Government bonds, privately-held wealth is generally backed by some real physical capital in the economy. Corporate bonds or corporate stocks, for example, are backed by the capital investments of corporations. Similarly, bank certificates of deposit are backed by the investment made by those borrowing from banks. In contrast, Government bonds are not backed by real capital, and do not represent any increment in capital for society. Government debt is backed only by the taxing power of the Federal Government.

Therefore, since savings used to purchase new Federal debt do not represent additions to the economy's capital stock, those savings have an illusory quality. For the individual saver, buying

Government bonds raises his or her private wealth, but, for the economy as a whole, Government debt does not add to the total capital stock of the economy. This is the essence of the crowding-out problem. For a given level of private wealth, the more that is accounted for by Federal Government debt, the less will be the economy's total real capital stock.

In 1980, Federal debt accounted for about 6.2% of total private wealth. By 1984, that figure had risen to 9.4%. If deficits were to continue at the levels projected on a current services basis, the share of total private wealth accounted for by Government debt would continue to grow rapidly. Thus far in this recovery, in spite of the growth of Federal debt relative to private wealth, domestic investment has not been crowded out. This has occurred partly because of the large net inflow of foreign savings. However, the long-term prospect of continued healthy growth in the real capital stock remains threatened unless the measures proposed in this budget to reduce the growth in Federal debt are enacted.

SENSITIVITY OF THE BUDGET TO ECONOMIC ASSUMPTIONS

Both receipts and outlays are strongly affected by changes in economic conditions. Budget estimates and projections, therefore, are a function of the economic assumptions upon which they are predicated, and are highly sensitive to changes in those assumptions.

The sensitivity of the budget aggregates to economic conditions seriously complicates budget planning because forecasting the economy inaccurately leads to forecasting the budget inaccurately, and economic forecasting is not an exact science. On the other hand, the budgetary impacts of a specific change in an economic assumption are generally fairly predictable. Therefore, an approximation to how the budget aggregates would change, given a specific set of changes in the economic outlook, can be calculated using rules-of-thumb.

Rules-of-Thumb.—In applying these rules, it is important to consider the combined effects of all economic variables that change. Many economic variables, such as real growth and the unemployment rate, are closely linked, and it may be unrealistic to assume a change in one without taking into account an associated change in the other. Again, if real growth changes, should the rate of inflation be assumed to be higher, lower, or unchanged? Should interest rates change? In a dynamic economy, the tendency is for a shock to be transmitted to almost every aspect of economic performance.

The table below shows, in its first bank of figures, the effects on receipts, outlays, and the deficit of a hypothetical sustained one

percentage point higher rate of inflation, beginning January 1986. It is assumed that real economic growth is unchanged, so that nominal GNP growth must also be one percentage point higher. Unemployment is assumed to be unchanged. With inflation a percentage point higher, interest rates are also assumed to be a percentage point higher. While nearly all receipts respond directly and immediately to inflation, the outlay effects shown are limited to those programs that respond automatically to inflation under current law, usually with a lag resulting from a cost-of-living adjustment procedure. Defense spending and Federal pay scales, for example, are not adjusted. Therefore, by 1990, the gain in receipts exceeds the increase in outlays by \$23 billion. Were more categories of outlays adjusted for the higher inflation, the gap would narrow, and possibly vanish.

The second bank of figures in the table shows the effect on the deficit of assuming a rate of real economic growth one percentage point lower than in the budget for the period 1986-90. No change in the rate of inflation is assumed, so the rate of growth of nominal GNP must also be a percentage point lower. Interest rates are assumed to be unchanged, but the unemployment rate is assumed to rise by 1 percentage point for each two percentage points that the level of real GNP falls below its base path.

The third bank of figures shows the budget implications of combining the first two banks of figures; that is, the effects of assuming no change in the rate of growth of nominal GNP, but a shift in the composition of that growth to one percentage point higher inflation and one percentage point lower real growth. Interest rates are assumed to be one percentage point higher, and the unemployment rate is assumed to be higher than in the base path in accordance with the same relationship as used in the second bank of figures. Except for some minor compounding effects, the third case is essentially the sum of the first two. Also, the effects shown are approximately symmetric, so that the effects of a percentage point *lower* inflation and *higher* real growth would be of the same magnitude as shown in the table, but of opposite sign.

The foregoing abstracts from possible changes in the assumed income share composition of GNP that would likely accompany any changes in the rate of real growth, the inflation rate, or interest rates. Because different GNP components such as wages and salaries, nonwage personal income, and corporate profits are subject to different taxes and tax rates, estimates of total receipts can be significantly affected by changing the income shares. These relationships are too complex, however, to be reduced to simple rules-of-thumb, and are not further considered here, although it is important to be aware of their existence.

ECONOMIC ASSUMPTIONS AND THE BUDGET 3-21

SENSITIVITY OF THE BUDGET TO RATES OF ECONOMIC CHANGE AND SHIFTS IN THE COMPOSITION OF NOMINAL GNP

(Fiscal years, in billions of dollars, current law basis)

	1986	1987	1988	1989	1990
Effect of a one percentage point change in annual nominal GNP growth rate resulting from:					
A one percentage point higher annual rate of inflation (and interest rates) beginning January 1986:					
Receipts.....					
Outlays.....					
Change in deficit.....					
A one percentage point lower annual rate of real growth beginning January 1986:					
Receipts.....					
Outlays.....					
Change in deficit.....					
Effect of a one percentage point higher annual rate of inflation (and interest rates) and a one percentage point lower annual rate of real growth, with no change in the annual nominal GNP growth rate, beginning January 1986:					
Receipts.....					
Outlays.....					
Change in deficit.....					

The final table of this section shows a disaggregated set of rules-of-thumb for the effects on outlays of changes in the unemployment rate, in interest rates, in Federal pay levels, and in inflation as it affects indexed programs subject to automatic cost-of-living adjustments (COLAs) under current law. For these COLAs, the effects are shown both on the basis of current law, and as they would be modified under the budget proposals. These effects were discussed in more detail in the 1985 budget.

Changes in the Budget's Sensitivity to Inflation.—Over the years, legislation has changed the automatic responses of the budget to inflation. A prime example is the indexation of individual income tax brackets, enacted in 1981, with the first adjustment effective this year.

Previously, this tax was extraordinarily sensitive to inflation because of "bracket creep." With graduated rates and brackets fixed in nominal terms, inflation pushed people into higher and higher marginal tax brackets, increasing the percentage of their income paid as income tax, even when their real income was unchanged. As a result, a percentage point of inflation that increased nominal personal incomes by a percentage point would increase individual income tax receipts by 1.5%, with the "extra"

SENSITIVITY OF THE BUDGET TO ECONOMIC ASSUMPTIONS

(Fiscal years, in billions of dollars)

	1985	1986	1987	1988	1989	1990
PRICES (EFFECT ON INDEXED PROGRAM OUTLAYS)						
Sustained one percentage point higher rate of inflation beginning:						
Under current law:						
January 1985.....		1.2	3.9	7.0	10.5	14.3
July 1985.....		0.4	2.6	5.7	9.1	12.8
Under proposed law:						
January 1985.....		0.5	2.4	5.2	8.3	11.6
July 1985.....			1.3	4.0	7.1	10.4
One-time one percentage point jump in price level occurring:						
Under current law:						
January 1985.....		1.7	2.6	2.6	2.8	2.8
July 1985.....		1.6	2.6	2.7	2.8	2.8
Under proposed law:						
January 1985.....		1.4	2.0	2.1	2.1	2.2
July 1985.....			1.6	2.2	2.2	2.3
INTEREST RATES (EFFECT ON NET INTEREST)						
Sustained one percentage point increase in interest rates under budget policy deficits, beginning: ¹						
January 1, 1985.....	2.2	7.1	10.3	13.5	16.5	18.1
July 1, 1985.....	0.3	5.7	9.5	13.1	16.0	18.0
Effect of assuming no decline in interest rates from current levels.....						
INTEREST COST OF HIGHER FEDERAL BORROWING						
Effect of \$100 billion borrowing in 1986 ²		5.2	9.4	9.3	8.7	8.1
UNEMPLOYMENT RATE						
One percentage point higher rate beginning January 1, 1985:						
Unemployment benefits.....	2.5	3.1	3.0	2.8	2.7	2.5
Other unemployment-sensitive outlays.....	1.0	1.8	2.0	2.0	2.0	2.0
FEDERAL PAY RAISES						
Outlay effect of one percentage point increase in October 1986:						
Military personnel.....			0.4	0.5	0.5	0.5
Civilian employees:						
Department of Defense.....			0.2	0.3	0.3	0.3
Civilian agencies.....			0.3	0.3	0.4	0.4
Employer share, employee retirement.....			-0.1	-0.1	-0.1	-0.1

¹ Omits increase in receipts due to higher Federal Reserve System deposits of earnings.² Includes subsequent interest on borrowing incurred to pay for previous interest costs.

half a percent due to "bracket creep." By adjusting the tax brackets for inflation, indexation eliminates the extra half percent "bracket creep," limiting the rise in receipts to the growth of nominal income.

Over the years, legislation has provided for automatic annual cost-of-living adjustments to benefits paid out under a growing number of entitlement programs such as social security, Federal employee retirement, and food stamps. The enactment of medicare and medicaid as open-ended entitlements created a category of

Federal program that is not explicitly indexed, but whose costs rise directly with increases in prices charged for medical care. For still other programs, such as aid to families with dependent children and unemployment compensation, Federal costs are determined by the actions of 50 State legislatures as they adjust benefits to reflect inflation.

Policies of targeting a specific rate of real growth for the defense budget have meant that the defense budget must be fully adjusted for inflation if the real growth target is to be achieved. Enactment of Federal pay comparability was designed to index Federal employee pay scales to private sector pay, but the automatic adjustments can be overridden by Presidential and congressional action.

With the responsiveness of receipts to inflation greatly reduced from what it used to be and the responsiveness of outlays increased, the deficit will not decline very rapidly due to continued moderate inflation. Policy action, such as the spending "freeze" proposed by the administration, are needed to reduce the deficit.

CHANGES IN THE BUDGET OUTLOOK SINCE LAST YEAR

The February 1984 budget projected 4.5% real GNP growth between the fourth quarter of 1983 and the fourth quarter of 1984. In fact, growth was much higher than that in the first half of the year, and significantly slower in the second half, with the 4-quarter change coming to 5.3%, 0.8% above the forecast. Partly in consequence, the unemployment rate in the fourth quarter of 1984 was 7.1%, 0.6 percentage points below the forecast of 7.7%.

The 4-quarter rise in the implicit price deflator for GNP, 3.7%, was significantly below the forecast of 5.0%; partly in consequence, the increase projected for 1985 has now been reduced from 4.7% to 4.3%. Overall, the 4-quarter change in nominal GNP, 9.2%, was 0.6% less than last year's forecast of 9.8%, as lower inflation more than offset higher real growth.

The 4-quarter rise in the Consumer Price Index, 3.6%, was 0.8 percentage points lower than the 4.4% forecast, resulting in a lower January 1985 cost-of-living adjustment to social security and other indexed programs' benefits than was projected last year.

Interest rates are now approximately at the levels forecast for the first quarter of this year, although their average levels during 1984 were one or two percentage points above forecast. Forecast errors for other economic assumptions bearing on the budget estimates were generally relatively small.

Since 1984 economic performance did not deviate markedly from expectation, it affords little basis for substantial change to the 1985-89 economic outlook. Indeed, the current assumptions for that period are virtually the same as the assumptions used a year ago. In consequence, the budget outlook, insofar as it is a function of

THE BUDGET FOR FISCAL YEAR 1986

COMPARISON OF FEBRUARY 1984 AND CURRENT ECONOMIC ASSUMPTIONS

(Calendar years, dollar amounts in billions)

	1984	1985	1986	1987	1988	1989
Nominal GNP:						
1984 forecast ¹	3,626	3,955	4,299	4,660	5,035	5,419
1985 forecast.....	3,560	3,942	4,278	4,635	5,009	5,391
Real GNP (percent change):						
1984 forecast.....	5.3	4.1	4.0	4.0	4.0	3.9
1985 forecast.....	5.7	3.7	4.0	4.0	4.0	3.9
GNP deflator (percent change):						
1984 forecast.....	4.5	4.8	4.5	4.2	3.9	3.6
1985 forecast.....	3.8	3.9	4.3	4.2	3.9	3.6
Interest rate on 91-day Treasury bills (percent):						
1984 forecast.....	9.5	7.7	7.1	6.2	5.5	5.0
1985 forecast.....	9.6	8.1	7.9	7.2	5.9	5.1
Unemployment rate (percent):						
1984 forecast.....	7.3	7.6	7.3	6.8	6.1	5.7
1985 forecast.....	7.4	7.0	6.9	6.6	6.3	6.1

¹ Adjusted for July 1984 historical revisions.

EFFECTS ON THE BUDGET OF CHANGES IN ECONOMIC ASSUMPTIONS SINCE LAST YEAR

(Fiscal years, in billions of dollars)

	1985	1986	1987	1988	1989
Current budget estimates ¹ adjusted to February 1984 forecast:					
Receipts.....					
Outlays.....					
Deficit (-).....					
Changes due to economic assumptions:					
Receipts.....	-6.8	-18.4	-16.5	-15.1	-17.7
Outlays:					
Inflation.....					
Unemployment.....	-2.5	-2.4	-1.1	0.2	1.5
Interest rates.....	2.4	2.7	5.2	3.0	-2.5
Interest on changes in borrowing.....					
Total, outlays.....					
Decrease in deficit (+).....					
Current budget estimates: ¹					
Receipts.....					
Outlays.....					
Deficit (-).....					
Addendum:					
Change in deficit due to:					
Actual 1984 economic performance.....					
Change in the forecast for 1985-1989.....					
Percent due to 1984 economic performance.....					

¹ Includes outlays that are off-budget under current law, but proposed to be placed on-budget.

economic assumptions, has changed relatively little since last year. The major difference is due to slightly lower inflation in 1984 and 1985, which reduces both receipts and outlays in all subsequent

ECONOMIC ASSUMPTIONS AND THE BUDGET 3-25

years, making relatively small net increases in the projected deficits.

Last year's budget estimates reflected considerable improvement in the economy and in the budget outlook since the preceding budget. This did not compensate, however, for the large declines that had by then occurred from the forecast in the March 1981 budget revisions, as shown below. In this context, the slight worsening of the budget outlook since last year (primarily attributable to lower than expected inflation) can be seen as a partial offset to the degree of improvement projected last year.

EFFECTS ON THE DEFICIT OF CHANGES IN ECONOMIC ASSUMPTIONS SINCE MARCH 1981

(Fiscal years, in billions of dollars)


	1982	1983	1984	1985	1986
Increase in deficit, March 1981-January 1983	70.0	167.3	197.7	224.6	252.3
Decrease in deficit, January 1983-February 1984		-11.8	-29.3	-37.2	-37.7
Increase in deficit, February 1984-February 1985					
Net increase in deficit, March 1981-February 1985	70.0	155.5			

THE WHITE HOUSE

WASHINGTON

July 9, 1985

MEMORANDUM FOR FRED F. FIELDING

FROM: JOHN G. ROBERTS 
SUBJECT: Draft Letter to Congressman Larry
Craig Regarding Balanced Budget

As discussed this morning. You should know that the Office of Legal Counsel determined in 1979 that an Article V convention could be limited to a particular issue. I did not cite this opinion (copy attached) in the attached draft memorandum, because it is little more than an ipse dixit refuted by the history of the original Constitutional Convention.

Attachment

THE WHITE HOUSE

WASHINGTON

July 9, 1985

MEMORANDUM FOR DAVID L. CHEW
STAFF SECRETARY

FROM: FRED F. FIELDING ^{Orig. signed by FFF}
COUNSEL TO THE PRESIDENT

SUBJECT: Draft Letter to Congressman Larry
Craig Regarding Balanced Budget

You have asked for comments on a proposed letter from the President to Congressman Larry Craig, stating that the President does not object to "a limited Constitutional Convention" called by the States for the purpose of proposing a balanced budget amendment. It is my strongly-held view that the President should not endorse the constitutional convention procedure for proposing amendments to the Constitution.

The convention route for amending the Constitution has never been tried and is rife with legal uncertainties. One thing that does seem clear is that the Executive has no formal legal role to play in the process, just as the Executive has no formal legal role in the other, more traditional method of proposing amendments to the Constitution. See Hollingsworth v. Virginia, 3 Dall. 378 (1798); Special Constitutional Convention Study Committee, ABA, Amendment of the Constitution by the Convention Method Under Article V, 25-28 (1974). While the President has of course endorsed particular proposed amendments, he has not, to my knowledge, endorsed the untested convention method.

The principal difficulty with supporting "a limited Constitutional Convention" is that it is unclear that any convention called by the States pursuant to Article V could be limited. Legal scholars are sharply divided on the question, but it is important to recall that the original Constitutional Convention was called "for the sole and express purpose of revising the Articles of Confederation." Once convened, the Framers went far beyond this limited mandate. The product of their transgression has served us well for almost two centuries, but the convening of another constitutional convention would put the entire Constitution at risk.

Perhaps a convention called pursuant to Article V could be limited to the balanced budget issue, but who would enforce such a limitation on the delegates? It would seem that their authority would be paramount to that of Congress, and it is reasonably well-established that the courts should abstain from interfering in the amendment process. As noted, the Executive has no formal role in that process. In short, there is the very real danger of a convention called for a limited purpose becoming a runaway convention, reconsidering the entire Constitution. That is precisely what happened in 1787, and I am not anxious to commemorate the bicentennial of the Constitution by redoing the Convention, particularly since Hamiltons, Madisons, and Jays seem in short supply.

I recommend that the letter not be sent.

FFF:JGR:aea 7/9/85
cc: FFFielding
JGRoberts
Subj
Chron

THE WHITE HOUSE

WASHINGTON

July 9, 1985

MEMORANDUM FOR DAVID L. CHEW
STAFF SECRETARY

FROM: FRED F. FIELDING
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SUBJECT: Draft Letter to Congressman Larry
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You have asked for comments on a proposed letter from the President to Congressman Larry Craig, stating that the President does not object to "a limited Constitutional Convention" called by the States for the purpose of proposing a balanced budget amendment. It is my strongly-held view that the President should not endorse the constitutional convention procedure for proposing amendments to the Constitution.

The convention route for amending the Constitution has never been tried and is rife with legal uncertainties. One thing that does seem clear is that the Executive has no formal legal role to play in the process, just as the Executive has no formal legal role in the other, more traditional method of proposing amendments to the Constitution. See Hollingsworth v. Virginia, 3 Dall. 378 (1798); Special Constitutional Convention Study Committee, ABA, Amendment of the Constitution by the Convention Method Under Article V, 25-28 (1974). While the President has of course endorsed particular proposed amendments, he has not, to my knowledge, endorsed the untested convention method.

The principal difficulty with supporting "a limited Constitutional Convention" is that it is unclear that any convention called by the States pursuant to Article V could be limited. Legal scholars are sharply divided on the question, but it is important to recall that the original Constitutional Convention was called "for the sole and express purpose of revising the Articles of Confederation." Once convened, the Framers went far beyond this limited mandate. The product of their transgression has served us well for almost two centuries, but the convening of another constitutional convention would put the entire Constitution at risk.

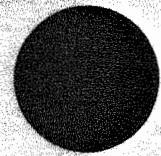
Perhaps a convention called pursuant to Article V could be limited to the balanced budget issue, but who would enforce such a limitation on the delegates? It would seem that their authority would be paramount to that of Congress, and it is reasonably well-established that the courts should abstain from interfering in the amendment process. As noted, the Executive has no formal role in that process. In short, there is the very real danger of a convention called for a limited purpose becoming a runaway convention, reconsidering the entire Constitution. That is precisely what happened in 1787, and I am not anxious to commemorate the bicentennial of the Constitution by redoing the Convention, particularly since Hamiltons, Madisons, and Jays seem in short supply.

I recommend that the letter not be sent.

FFF:JGR:aea 7/9/85

cc: FFFielding
JGRoberts
Subj
Chron

WHITE HOUSE CORRESPONDENCE TRACKING WORKSHEET



O - OUTGOING

H - INTERNAL

I - INCOMING

Date Correspondence Received (YY/MM/DD) 1 1

Name of Correspondent: D Chew

MI Mail Report

User Codes: (A) _____ (B) _____ (C) _____

Subject: Draft letter to Congressman Larry Craig re Balanced Budget

ROUTE TO:

ACTION

DISPOSITION

Office/Agency (Staff Name)	Action Code	Tracking Date YY/MM/DD	Type of Response	Code	Completion Date YY/MM/DD
<u>CUMHOLL</u>	<u>ORIGINATOR</u>	<u>85,07,08</u>			<u>1 1</u>
	Referral Note:				
<u>CUAT 18</u>	<u>R</u>	<u>85,07,08</u>		<u>S</u>	<u>85,07,09</u>
	Referral Note:				<u>COB</u>
		<u>1 1</u>			<u>1 1</u>
	Referral Note:				
		<u>1 1</u>			<u>1 1</u>
	Referral Note:				
		<u>1 1</u>			<u>1 1</u>
	Referral Note:				

ACTION CODES:

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- C - Comment/Recommendation
- D - Draft Response
- F - Furnish Fact Sheet to be used as Enclosure

- I - Info Copy Only/No Action Necessary
- R - Direct Reply w/Copy
- S - For Signature
- X - Interim Reply

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- C - Completed
- S - Suspended

FOR OUTGOING CORRESPONDENCE:

- Type of Response = Initials of Signer
- Code = "A"
- Completion Date = Date of Outgoing

Comments: _____

Keep this worksheet attached to the original incoming letter.
 Send all routing updates to Central Reference (Room 75, OEOP).
 Always return completed correspondence record to Central Files.
 Refer questions about the correspondence tracking system to Central Reference, ext. 2590.

WHITE HOUSE STAFFING MEMORANDUM

DATE: 7/8/85 ACTION/CONCURRENCE/COMMENT DUE BY: c.o.b. July 9th

SUBJECT: Draft Letter to Congressman Larry Craig

	ACTION	FYI		ACTION	FYI
VICE PRESIDENT	<input type="checkbox"/>	<input type="checkbox"/>	LACY	<input type="checkbox"/>	<input type="checkbox"/>
REGAN	<input type="checkbox"/>	<input checked="" type="checkbox"/>	McFARLANE	<input type="checkbox"/>	<input type="checkbox"/>
STOCKMAN	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OGLESBY	<input checked="" type="checkbox"/>	<input type="checkbox"/>
BUCHANAN	<input checked="" type="checkbox"/>	<input type="checkbox"/>	ROLLINS	<input checked="" type="checkbox"/>	<input type="checkbox"/>
CHAVEZ	<input checked="" type="checkbox"/>	<input type="checkbox"/>	RYAN	<input type="checkbox"/>	<input type="checkbox"/>
CHEW	<input type="checkbox"/>	<input checked="" type="checkbox"/>	SPEAKES	<input type="checkbox"/>	<input type="checkbox"/>
DANIELS	<input type="checkbox"/>	<input checked="" type="checkbox"/>	SPRINKEL	<input type="checkbox"/>	<input type="checkbox"/>
FIELDING	<input checked="" type="checkbox"/>	<input type="checkbox"/>	SVAHN	<input checked="" type="checkbox"/>	<input type="checkbox"/>
FRIEDERSDORF	<input checked="" type="checkbox"/>	<input type="checkbox"/>	TUTTLE	<input type="checkbox"/>	<input type="checkbox"/>
HENKEL	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
HICKEY	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
HICKS	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
KINGON	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>

REMARKS: Attached is a proposed letter to Congressman Craig indicating that the President does not object to a constitutional convention as a means of securing a balanced budget amendment to the constitution. Any questions about the letter should be addressed to Mitch Daniels.

RESPONSE:

1985 JUL -8 PM 3:47

David L. Chew
Staff Secretary
Ext. 2702

SAMPLE DRAFT LETTER TO CONGRESSMAN LARRY CRAIG

Dear Larry:

I am writing to acknowledge the leadership contributed by members of Congressional Leaders United for Balanced Budget (CLUBB) in advancing the course of a balanced budget amendment to the Constitution. I have observed closely your activities both in Washington and in state legislatures around the country, and I am grateful to you for your hard work on both fronts.

In the ideal case, Congress would have acted long ago to respond to the overwhelming public opinion favoring an amendment. Over the years, it has become obvious that the current Congress will vote to limit its own spending only under the most intense pressure. Absent the state petition drive, the balanced budget amendment would have continued to languish without serious consideration.

I am not among those who are alarmed by the resolutions calling for a limited Constitutional Convention should Congress refuse to act. The state petition process, with its many safeguards, was written into the Constitution precisely for situations in which Congress refuses to respond to the will of the people. Moreover, the reaction of Congress to those petitions already received suggests that Congress would ultimately submit an amendment to the states before allowing a Convention to occur.

Please relay my thanks to each of your fellow CLUBB members, and keep up the good work. Together we will accomplish a reform of great benefit for all future generations of Americans.

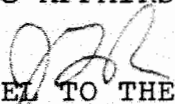
Sincerely,

Ronald Reagan

THE WHITE HOUSE
WASHINGTON

January 16, 1986

MEMORANDUM FOR TOM GIBSON
SPECIAL ASSISTANT TO THE PRESIDENT
DIRECTOR, PUBLIC AFFAIRS

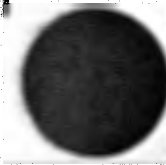
FROM: JOHN G. ROBERTS 
ASSOCIATE COUNSEL TO THE PRESIDENT

SUBJECT: Draft Talking Points on
Additional Budget Themes

Counsel's Office has reviewed the above-referenced draft talking points, and finds no objection to them from a legal perspective.

cc: David L. Chew

WHITE HOUSE CORRESPONDENCE TRACKING WORKSHEET



- O - OUTGOING
- H - INTERNAL
- I - INCOMING

Date Correspondence Received (YY/MM/DD) 1 1

Name of Correspondent: Paul Chew

MI Mail Report User Codes: (A) _____ (B) _____ (C) _____

Subject: Want talking points on additional Budget Themes

ROUTE TO:	ACTION	DISPOSITION		
Office/Agency (Staff Name)	Action Code	Tracking Date YY/MM/DD	Type of Response Code	Completion Date YY/MM/DD
<u>CUHOLL</u>	ORIGINATOR	<u>86/01/16</u>		<u>1 1</u>
<u>CUAT 18</u>	Referral Note: <u>R</u>	<u>86/01/16</u>	<u>S</u>	<u>86/01/16</u> <u>130 PM</u>
	Referral Note:	<u>1 1</u>		<u>1 1</u>
	Referral Note:	<u>1 1</u>		<u>1 1</u>
	Referral Note:	<u>1 1</u>		<u>1 1</u>

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Comments: _____

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 Always return completed correspondence record to Central Files.
 Refer questions about the correspondence tracking system to Central Reference, ext. 2590.

WHITE HOUSE STAFFING MEMORANDUM

DATE: 1/16/86 ACTION/CONCURRENCE/COMMENT DUE BY: 1:30 TODAY

SUBJECT: DRAFT TALKING POINTS ON ADDITIONAL BUDGET THEMES

	ACTION FYI			ACTION FYI	
VICE PRESIDENT	<input type="checkbox"/>	<input checked="" type="checkbox"/>	OGLESBY	<input checked="" type="checkbox"/>	<input type="checkbox"/>
REGAN	<input type="checkbox"/>	<input checked="" type="checkbox"/>	POINDEXTER	<input checked="" type="checkbox"/>	<input type="checkbox"/>
MILLER	<input checked="" type="checkbox"/>	<input type="checkbox"/>	RYAN	<input type="checkbox"/>	<input type="checkbox"/>
BUCHANAN	<input checked="" type="checkbox"/>	<input type="checkbox"/>	SPEAKES	<input type="checkbox"/>	<input checked="" type="checkbox"/>
CHAVEZ	<input checked="" type="checkbox"/>	<input type="checkbox"/>	SPRINKEL	<input checked="" type="checkbox"/>	<input type="checkbox"/>
CHEW	<input type="checkbox"/>	<input checked="" type="checkbox"/>	STEELMAN	<input type="checkbox"/>	<input type="checkbox"/>
DANIELS	<input checked="" type="checkbox"/>	<input type="checkbox"/>	SVAHN	<input checked="" type="checkbox"/>	<input type="checkbox"/>
FIELDING	<input checked="" type="checkbox"/>	<input type="checkbox"/>	THOMAS	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HENKEL	<input type="checkbox"/>	<input type="checkbox"/>	TUTTLE	<input type="checkbox"/>	<input type="checkbox"/>
HICKS	<input type="checkbox"/>	<input type="checkbox"/>	<u>GIBSON</u>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
KINGON	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
LACY	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>

REMARKS:

Please submit any comments directly to TOM GIBSON by 1:30 this afternoon, with an information copy to my office. Thanks.

RESPONSE:

THE 1987 BUDGET: NATIONAL DEFENSE PRESERVED

Status of Restoring America's Security

- o During the 1970s, the United States seriously underfunded defense programs.
 - From 1970 to 1981, U.S. defense spending declined nearly 20 percent in real terms.
 - As a percentage of the GNP, defense spending declined to 5% by 1978, from a level of about 9% during the 1950s and early 1960s.
 - During the 1970s, the Soviet Union outpaced our defense spending effort by about 50 percent.
- o In the past five years of the Reagan Administration, we have reversed this alarming decline in defense and have made significant progress in strengthening our military capabilities. We now possess the most effective American military we have ever had in peacetime.

Why Not Cut Defense?

- o Providing for America's security is the unique obligation of the federal government. No other American institution can spend on national defense.
- o In contrast, most domestic programs targeted for reductions can be effectively performed by the private sector, or by state or local governments -- which together ran a multi-billion dollar budget surplus in 1985.
- o The choice presented in the President's budget is clear: preserving defense, or turning back the clock to the late 1970s, when half of our planes couldn't fly and our Navy's ships couldn't sail for lack of parts and trained support.
- o The President agreed to a pause in rebuilding our defenses last year, as part of a budget compromise with the Congress. The compromise was intended to provide zero real growth for defense in FY 1986.
- o Congress actually provided less than zero real growth for defense -- and with the additional Gramm-Rudman-Hollings automatic reductions for FY 1986, defense will decline about 5 percent in real terms.
- o With all of the talk about Defense spending growth, the Defense budget, as a percent of GNP is still low. It is now about 6% -- well below the 9.7% of 1960, and smaller than in any year of the Kennedy-Johnson administration.

- o Moreover, Soviet military expansion continues -- the current Defense budget of the Soviet Union consumes 15% of their GNP.
- o An abrupt turnaround in Congressional support for essential defense spending would simply result in false economies -- and jeopardize national security interests:
 - Stop-and-go procurement and stretch-outs are extremely expensive. We end up with less equipment at much higher costs per item.
 - In many cases personnel would not be available to run military equipment already approved by Congress;
 - Maintenance would suffer, training would deteriorate, and crew proficiency would be undermined;
 - The reduced quality of life for service personnel would hurt morale and increase turnover. Higher turnover means higher training costs for raw recruits.
- o On defense, the President has already given at the office.

THE 1987 BUDGET: MEETS GRAMM-RUDMAN-HOLLINGS TARGETS, INTELLIGENTLY

- o Contrary to widespread misunderstanding, Gramm-Rudman-Hollings does not dictate how or where cuts in federal spending will occur. It is a process, now the law, that will force the federal government to meet specific deficit reduction targets en route to a balanced budget in FY 1991.
- o Gramm-Rudman-Hollings will be triggered only if Congress abdicates its Constitutional responsibility and fails to pass a budget that meets those targets.

Why Pass the Administration's Budget?

- o The Administration's Budget for FY '87 is a reasoned and defensible determination of what federal spending priorities should be.
 - Preserves social spending for the needy;
 - Preserves spending for health, safety, and other services that benefit the general population (air traffic controllers, OSHA inspectors, drug interdiction efforts, AIDS research, etc.);
 - Preserves spending to restore America's defense capability, a function performed only by the federal government; and
 - Removes the government from activities that have outlived their usefulness, or which the government has no business undertaking.
- o The President's FY 1987 budget will meet the \$144 billion deficit target required under Gramm-Rudman-Hollings -- without raising taxes.
- o The President's budget looks forward to America's future. America's government should be lean and efficient -- to match the spirit and drive of the American people. Surplus property, antique agencies that serve no useful purpose, and the massive overspending intended to placate the special interests, should be shed.
- o Alternatives to the President's budget are unacceptable:
 - 1) Higher taxes. The President will oppose higher taxes because they will choke off the record economic growth and job creation that have characterized "Reaganomics" for the last 39 months.
 - 2) Arbitrary cuts under the automatic process of Gramm-Rudman-Hollings. Across-the-board cuts would result in jeopardizing priorities along with programs.

THE 1987 BUDGET: SOCIAL SECURITY AND
ESSENTIAL SPENDING FOR THE NEEDY PRESERVED

- o The President will submit a FY 1987 budget that meets the \$144 billion deficit target without cuts in Social Security or cuts in essential programs for the truly needy.

Social Security

- o The President has long believed that revenues and expenditures under the Social Security system bear no relation to the size of the federal deficit. The system is separate from the rest of the federal budget and, in 1985, ran a surplus.
- o Gramm-Rudman-Hollings properly exempts Social Security benefits from automatic spending cuts.

Essential Spending for the Needy

- o Within an overall climate of fiscal responsibility, the Reagan Administration will help meet the needs of individuals by insuring against loss of income resulting from retirement, disability, death, or unemployment of a wage earner, and by assisting the truly needy who are unable to provide for themselves.
- o The President believes that this commitment to programs in the social safety net transcends differences of ideology and partisanship. Overall, "safety net" spending (including Social Security and unemployment insurance) is up \$63 billion since 1981.
- o For those who choose to measure "fairness" in budget terms, the Reagan budget will propose spending over \$2.5 trillion on human needs over the next five years -- significantly more than will be spent for defense over the same period.
- o Moreover, state and local governments will spend about times as much as the federal government on social programs over the next five years.
- o Not every federal program defended in the name of the disadvantaged can or should be considered essential. The President's FY 1987 budget will propose management reforms and efficiencies that will trim costs, improve service delivery, and help ensure that tax dollars are spent on essential programs to aid the truly needy.

THE 1987 BUDGET: NO TAX INCREASES

- o The President will submit a FY 1987 budget that hits the \$144 deficit target without new taxes.
- o In 1984, one candidate spoke of the need for sharply higher taxes to close the deficit gap. The other candidate, Ronald Reagan, swept to reelection with a 49-state mandate to curb government spending through fiscal restraint.

Higher Taxes No Cure

- o Reducing the deficit through tax hikes would impose substantial new tax burdens on American households. For example, assuming no spending reductions, a \$50 billion tax increase would be needed to achieve the FY 1987 deficit target.
- o A tax increase of this size would increase the total tax burden by over \$500 on the average American household, or increase personal income taxes for every taxpayer by about 12 percent this year.
- o If only \$25 billion of the deficit savings were to come from increased personal income taxes, the total income tax burden on the average family of four would increase \$248.
- o As experience has proven, higher taxes reduce incentives for Americans to work, save and invest -- thus choking off the creation of new jobs.
- o The Reagan economic agenda has put more than 9 million additional Americans to work since November 1982. That is more job creation than our European allies, with their high personal and business taxes, have been able to provide their citizens in the past decade.

Revenue Holding Steady

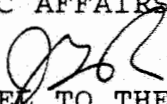
- o The Reagan tax cuts did not cause the deficit. Federal tax revenues, which had soared to a record 21 percent of GNP in the final year of the previous administration, have been stabilized at about 19 percent of GNP -- right in the 18-19 percent range that prevailed from 1952-1979.
- o Federal spending has gotten out of hand. While taxes have remained relatively unchanged as a share of GNP, spending has steadily increased to 25% of GNP in 1985 -- up substantially from the 20.5 percent average of 1964 through 1979.
- o For every extra dollar a prosperous America has sent to Washington in the past four years, the federal government took that dollar and spent an additional dollar. From FY 1981 to FY 1985, total revenues increased by 22 percent, while, despite the President's efforts to rein in federal spending, total spending increased by 39 percent.

THE WHITE HOUSE

WASHINGTON

January 17, 1986

MEMORANDUM FOR TOM GIBSON
SPECIAL ASSISTANT TO THE PRESIDENT
DIRECTOR, PUBLIC AFFAIRS

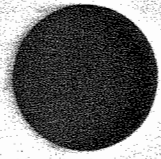
FROM: JOHN G. ROBERTS 
ASSOCIATE COUNSEL TO THE PRESIDENT

SUBJECT: FY '87 Budget Themes

Counsel's Office has reviewed the above-referenced budget materials, and finds no objection to them from a legal perspective.

cc: David L. Chew

WHITE HOUSE CORRESPONDENCE TRACKING WORKSHEET



O - OUTGOING

H - INTERNAL

I - INCOMING

Date Correspondence Received (YY/MM/DD) 1 / 1

Name of Correspondent: Dave Chew

MI Mail Report

User Codes: (A) _____ (B) _____ (C) _____

Subject: FY 187 Budget Themes

ROUTE TO:

ACTION

DISPOSITION

Office/Agency (Staff Name)	Action Code	Tracking Date YY/MM/DD	Type of Response	Code	Completion Date YY/MM/DD
<u>CULHOLL</u>	ORIGINATOR	<u>86,01,17</u>			<u>1 / 1</u>
<u>Chat 18</u>	<u>B</u>	<u>86,01,17</u>	<u>?</u>	<u>S</u>	<u>86,01,17</u> <u>1 PM</u>
		<u>1 / 1</u>			<u>1 / 1</u>
		<u>1 / 1</u>			<u>1 / 1</u>
		<u>1 / 1</u>			<u>1 / 1</u>

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