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MEMORANDUM

To: Roger Ailes

From: Lawrence A. Kudlow

Date: July 2, 1992

One of the key voter themes in this election year is a growing rebellion against overly expensive and frequently corrupt government, especially the Federal government in Washington.

Millions of Americans who read almost daily in their newspapers of large scale layoffs by giant corporations such as IBM, GM, Citicorp and many others wonder why it is that they never read of significant employment reductions in the Federal government. Indeed, many people who have lost their jobs in these corporate downsizing and restructurings, or know of friends who have been laid off, are bewildered at the lack of shared sacrifice by the government.

What's more, it seems to large numbers of people that while they have been forced to shoulder significantly higher tax burdens imposed by politicians at the Federal, state and city levels, it is their tax payments and eroding paychecks which support ever expanding government programs and bureaucratic personnel to implement these programs. Or check bouncing in the House, or illegal drug trading in the Post Office. Or a myriad of special interest programs and subsidies which never even remotely benefit the average family.

When was the last time anyone read of a sizable layoff at the Dept. of Health and Human Services (HHS), or Labor, or Commerce, or the Congressional staff? When was the last time anyone read of the *elimination* of a large number of Federal programs which are deemed nonessential? Or that the government has wisely decided to withdraw from high-cost activities which are inefficiently managed and benefit only a tiny group?

The Federal government today is a dinosaur, using a massive assembly line labor intensive approach that not even Detroit carmakers employ anymore. When will the government be brought into the high-tech, high-speed, computerized information age? When will the government generate more service output with fewer workers, as all US businesses are doing?

It is precisely this sort of downsizing, restructuring, re-prioritzing and withdrawal from unprofitable businesses which has been the dominant characteristic of private enterprise in America in order to become competitive in the new globally competitive economy. But why is it that government, especially the Federal government , remains oblivious to the discipline of the competitive market-place?

If companies fall into the red, then they must take stern action to pare down wasteful and expensive operations, even if it means layoffs. Yet a Federal government which is running upwards of $300 to $400 billion in red ink takes no such action. Most Americans work for a living and understand the business cycle. Unlike most elected politicians, staff members, reporters, broadcasters and T.V. talking heads, working Americans understand the need to act decisively in business to avoid disaster.

They understand why expenses must be scrutinized, line by line, every year. They understand why the *level* of expenses, not just the growth rate, must often be reduced. But they do not understand how an obviously bankrupt Federal government can go on losing unheard of sums of money and not take action. Nor can they understand why ever larger tax payments sent to Washington still result in ever expanding budget deficits. And still no strong management actions are taken.

Thus confusion and dismay have turned into the anger of a full-scale rebellion. It is not however the tax revolt of the late 'Seventies or early

And it is precisely this revolt against expensive government which has spawned the candidacy of Ross Perot. Despite his complete lack of government experience or service, voters seem to be investing their confidence in him because he is a blunt, tough-talking businessman whose fortune was self-made in the rough and tumble world of business.

Voters sense in him the characteristics of a man of action who will put the Federal government on a competitive business basis, unafraid of hard decisions to terminate programs or lay off employees. Although Perot has yet to put forward a clear blueprint to balance the budget, voters this spring appear to believe that he more than Governor Clinton or President Bush is the man to reform Washington.

It may be, however, that Perot's lack of a clear game plan provides an important opening for President Bush. In this sense the President, himself a businessman, must show clarity of purpose by generating a policy program to unambiguously downsize, restructure and reprioritize government operations.

The President should not, however, be lulled into supporting the balanced budget amendment proposed in Congress by Senator Simon and Representive Stenholm. These amendments leave wide open the possibility of massive tax increases in the years ahead, tax hikes which would lead to even worse economic performance in the future.

Instead, the President should propose a tough spending freeze that would apply across-the-board. What's more, Bush should make clear his determination to eliminate hundreds of unnecessary, wasteful and low priority programs. Also, he should explicitly state his intention to eliminate several hundred thousand jobs, perhaps 300,000 to 500,000 over the next 5 to 10 years, thereby providing the first significant reorganization and reduction of government since the end of World War II. What's more, the President should sell as many direct loans. This move would not affect the beneficiaries, but it would permanently reduce overhead and raise some money.

The President should admit candidly to the public that the Federal government is the only institution in American life that has avoided this sort of modernization. Large and small corporations have done it, so have colleges and universities, foundations, think tanks, non-profits, hospitals, even the major T.V. broadcasting network companies. Even state and local governments are doing it. Witness the welfare cuts and personnel reductions in Michigan, Illinois, Wisconsin and Massachusetts. Or the downsizing and privatization in Chicago, Phoenix and Newark.

Now it is time for the Federal government to do it. But raising taxes under the guise of a balanced budget amendment will only fund the beast, not tame it. Instead, Bush's spending freeze must be expressly designed to shrink government, not sustain it. This is a key point. Not only because very few people believe that they are under-taxed, but more to the point because they are furious at the lack of discipline and modernization which is characteristic of an overly expensive government that is generating a constant flow of red ink. Not only is it unfair, avoiding the discipline of private enterprise in the competitive marketplace, but it has become a national and international embarrassment.

One final point. Until such a thorough overhaul and reduction in government takes place, most people will expect higher future tax-rates. In this sense the disastrous budget deal of 1990 may provide a look at the future. With the deficit threat of higher tax-rates, the supply of high-risk direct investment capital necessary to finance a flood of job-creating new business starts will continue to be withheld, as has been the case since the late 'Eighties, and thus economic growth will be held hostage.

Indeed, without government downsizing, most people expect future tax-pro-growth tax-cut proposals, are simply not credible without a serious restructuring of Federal operations to eliminate the deficit.

In other words, bloated and overly expensive government, and its mega budget deficits, will continue to block any future tax-rate reductions unless massive government management change is implemented. With this in mind, the budget freeze to reduce and reinvent modernized government should go hand in hand with the capital gains tax cut to restart new business formation and new job creation. In this way President Bush can create a new metaphor of change which will be both credible and effective.

THE GLOBAL SPECTATOR

June 15, 1992

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BALANCED BUDGET AMENDMENT

I am pleased to testify before the Senate Budget Committee on the proposals for a balanced-budget amendment. In addition to my technical views on the proposed amendments, I want to address some broader economic policy issues that are important to the Federal budgeting process. As you know from my prior appearances before this committee and others, I am a strong advocate of economic growth. I feel that fiscal policy should have as its principal objective the generation of as strong a rate of economic growth, employment and business creation as possible. Obviously, unemployed people don't pay taxes, which damages the budget and financial situation.

Growth has been weak

The key problem in recent years is that our economy has hardly grown. We have had a period of stagnation, then recession, and over the last year a very subpar recovery. Real GDP has grown at an average rate of seven-tenths of one percent over the last 13 quarters, so it is no wonder that the budget has deteriorated to the extent it has. I want to underscore this point because any policy actions taken on the budget — be they constitutional amendments, or other forms of rule-making, or improvements in the budget process — must be geared towards the goal of economic growth.

Some strong actions should be taken. Senator Paul Simon mentioned in his report that this is the time for prompt and meaningful action. I agree with that. The status quo is not sustainable. The question is what kind of action should be taken?

As someone who has now been working in the financial markets for seven years since leaving the Federal government, I suppose that I ought to say interest rates will

Statement by Lawrence A. Kudlow before the Senate Budget Committee, U.S. Congress, Washington, D.C. June 10, 1992.

come down sharply if we can have some kind of balanced budget or meaningful deficit reduction. That may be true as long as the reduction is credible, although we have never been able to prove quantitatively that there is a clear relationship between the budget deficit and interest rates. However, I think most people in business, banking and finance would prefer to see a balanced budget rather than our current unbalanced position.

Future tax-rate uncertainty

Economic activity is being held back by uncertainty over the future course of taxes. The 1990 budget agreement, which was supposed to reduce the deficit by a combination of spending cuts and tax increases, did not receive a positive reaction from the financial markets. Instead, the economy's recession deepened, and almost all of the estimates of the budget deficit have deteriorated substantially. Instead of lower deficit estimates, we now have significantly higher deficit estimates. Instead of lower spending estimates, we have significantly higher spending estimates. Instead of higher revenue estimates, the actual revenue performance has been weaker than expected. Therefore, not surprisingly, there is renewed interest in additional fiscal action.

I think the budget deficit is a symptom of excessive Federal spending that has damaged investor confidence, since they fear that it implies future tax increases. *In other words, one of the reasons that I am interested in a constitutional amendment to balance the budget, provided that it is structured and written properly, is that it will eliminate an important source of uncertainty.* In my opinion, people of means, people of business, people who are in the investment world, are withholding capital because they are concerned that future budget deals, like the 1990 summit, will raise tax-rates, reduce after-tax investment returns, and harm the economy. The longer these deficit and budget issues go unattended, the more we will suppress and freeze and inhibit the basic function of business and financial investment, which in turn will hold back the animal spirits of this recovery.

The budget quagmire, and within that the ongoing threat that we are going to see significant tax rate increases in the next few years, is holding back the supply side of the economy. We are not getting the kind of direct business investment which is necessary to create either larger businesses or new businesses. As a result, job creation has been weak. Nonfarm payrolls, the most widely used measure of jobs, have increased by a mere 0.2% over the last 12 months. This uncertainty is a major impediment or barrier to a normalized economy, a normalized recovery and normalized investment.

Federal spending is out of control

The second major point I want to make is not surprising to this committee. *Federal spending is out of control, despite the best efforts of various measures such as Gramm-*

Rudman and the 1990 deal. The Treasury's latest monthly statement, which contains data on the budget through April or the first seven months of the current fiscal year, demonstrates the point clearly: Medicaid is growing 30% year on year; Medicare is growing at 15.8% year on year; and income security accounts are growing at 16.7% year on year. These are unprecedented rates of increase.

A look back at the spending side over the last three to three and a half years reveals similar trends. Over that time, Medicaid has grown at an annual average rate of 19%. In inflation-adjusted terms, unemployment compensation has grown by 13.5%, food and nutrition assistance by 9.2%, other income security, which is largely the SSI, by 8.8%. These are huge increases. No one who looks at these numbers can feel confident that the current level of tax-rates can remain as they are.

This unease is heightened by the size of the overall deficit, which I estimate will come in at $291 billion in fiscal year 1992, excluding both deposit insurance costs and residual costs of the Persian Gulf War. Including deposit insurance, my projection is $325 billion.

So the root causes of our budget imbalance are twofold: number one, the lack of economic growth in the last three and a half years; number two, excessive Federal spending. In fact, going back 20 or 25 years and looking at GDP shares, what is surprising is that the revenue side of the equation has been relatively stable at about 17.5% to 18.5% of GDP on average. Meanwhile, outlays have increased from about 17% of GDP to almost 25% of GDP. These historical trends, along with current budget trends, make it very clear that the problem is spending. *With overspending and large budget deficits, the business community is very concerned that future tax increases are going to interfere with their operations.*

Balanced budget proposals

It is time for action, and Senator Simon is right to raise the balanced-budget amendment. He is provoking and creating a terrific national debate in a Presidential election year, which is a good thing. I myself do not support his particular amendment, but I think in a generic sense a constitutional amendment to balance the budget is a good thing, if it is structured properly. I want to walk through some of the issues that are involved.

I believe an amendment should be directed primarily at the spending side. I would prefer to see a subcomponent in such an amendment that freezes Federal spending in the aggregate. I have long advocated a freeze. When I worked in the Office of Management and Budget, I advocated it. As a private citizen, I continue to advocate it. The Federal Government spends too much and absorbs too many resources. As such, the language of any balanced budget amendment should focus principally on Federal spending.

It is worth drawing from the experience of corporate restructurings in recent years. I think most people in the private sector agree the Federal government is the only major institution in our society which has not gone through a difficult restructuring and downsizing, as virtually every private business has had to undergo in the last ten years. In a sense, the Federal government's operations, its staffing levels, its programmatic reach resembles a kind of industrial dinosaur of the late 1950's or early 1960's. It hasn't modernized, hasn't gone through significant cost cutting, and is simply uncompetitive on a worldwide basis.

We read in the paper almost daily that, even ten years after the restructuring of business began, large American corporations are still going through a second or third or fourth round of downsizing, restructuring, refinancing and reprioritizing of the businesses they are in; yet, we do not read any such restructuring occurring at the Federal government level. This is one of the sources of voter taxpayer frustration and anger, which has reflected itself in the candidacy of a certain businessman from Texas. People are asking why the Federal government is still so expensive, still so large, still involved in so many areas, when so many private companies around the country have had a completely different attitude.

I think most Americans believe that there are many government programs that could be completely eliminated without any negative effect on our economy or service provision. I doubt if there are many Americans at this point who wouldn't rally to demand less expensive government. It isn't so much a tax revolt that I am describing, such as we had in California and nationally in the late 1970's and early 1980's. It is more a revolt against expensive government at all levels.

Budget reform at the state level

I am not an expert on each of the 50 states, but it seems to me the states are doing a rather better job under a balanced budget constraint than the Federal government is doing without one. This is important to note, since the states are often laboratories and leading indicators of voter sentiment. Despite the recent recession/stagnation period, large industrial states have taken major steps to reduce employment staffing levels, to roll back programs, even in a recession to roll back welfare spending, which is a very painful policy approach. States like Illinois, Michigan, Wisconsin and Massachusetts have taken sharp measures to reduce Medicaid and welfare-related outlays, and to put their budgets into balance without raising taxes. Even in my home state of New York, which has not been a leader in the fiscal reform, there is evidence that this is occurring. In California, after a large tax increase, the second pass by the government dealt more properly with the excesses on the spending side. In other words, the downsizing of American business is beginning to take hold at the state government level.

Abolish the current services baseline

I would also raise the following point, which, while technical, has great policy implications. *I can think of no technical issue more damaging to the financial balance of our government than the accounting convention called the current services baseline, which was put into the 1974 Budget Reform Act.* The current services baseline directly misinforms those who evaluate the budget. No business in this country operates a three- to five-year planning horizon on a forecasted baseline basis. Business operates from the level of actual expenses in the prior year and then goes forward to evaluate its staffing, planning, investing, and operating.

The Federal government operates in a way that virtually no American can understand. Suppose I want to go out and buy an automobile. I am feeling in a good mood and I decide I am going to buy a $35,000 car. It is a forecast. That is my forecast. So I go up to the showroom. I look at the car, kick the tires, inspect the sticker, and decide that I am not going to buy it. The Congress would score that as a $35,000 budget cut, even though no actual money was involved. If instead of buying a $35,000 car, if I decide to buy a $20,000 car, the Congress would score that as a $15,000 budget cut. Then some member of Congress might go on a national television show and say, "This is a real painful cut." It is not.

This is where the advice of Keynesian demand-side economists, who argue that budget cuts necessary to eliminate the deficit will depress aggregate spending in the economy, is misleading. It is important to realize that except for the defense function, which will decline quite apart from the balanced budget amendment debate because of the end of the cold war, no major functional account will experience a decline in the level of its spending, probably in our lifetime. That is to say, the spending cuts involve lower rates of growth in government spending than are *forecast* in the current services baseline. But the cuts do not imply declines in the *actual* level of spending. The Keynesian analysis from the General Theory onward dealt with cuts in the level of expenditures in the context of the national income and product accounts. It did not deal with the current services baseline or a lower rate of change of Federal spending.

What we are talking about here with respect to Senator Simon's amendment and its implications is a slower growth rate of spending. We are not talking about wreaking havoc on the American economy, because the level of spending won't actually fall from $1.3 trillion to $1.1 trillion. It simply means that while it won't go to $1.5 trillion the following year, it will still show an increase. So I believe the current services baseline just cuts to the very core of these issues, misleads, misinforms, creates mistaken economic analysis and doom-and-gloom scenarios of what a balanced budget will do to the economy.

The 1974 Budget Reform Act, also reduced presidential impoundment authority. While it may be unpopular with Congress, some form of presidential impoundment authority has to be restored, whether it is a line item veto, enhanced recission or enhanced deferral authority. This, in my judgment, is a nonpartisan issue. Again, I will draw analogies from the business sector. If you talk to CEO's, if you go down to the Business Roundtable and so forth, they are astonished at how little executive authority actually exists over budget and financial matters.

Don't raise taxes

I approach with fear and trembling the tax implications of the various Stenholm amendments. If, as some people have been quoted, the underlying design of policy in the aftermath of passage of a balanced budget amendment includes a 50% increase in taxes and a 50% reduction in the current services spending baseline, it is a prescription for economic disaster. On this point I want to go on the record. *A country suffering through recession, stagnation and subpar recovery does not need significant tax increases. If a balanced budget amendment requires higher taxes as part of a five-to-seven year solution, then I oppose it.*

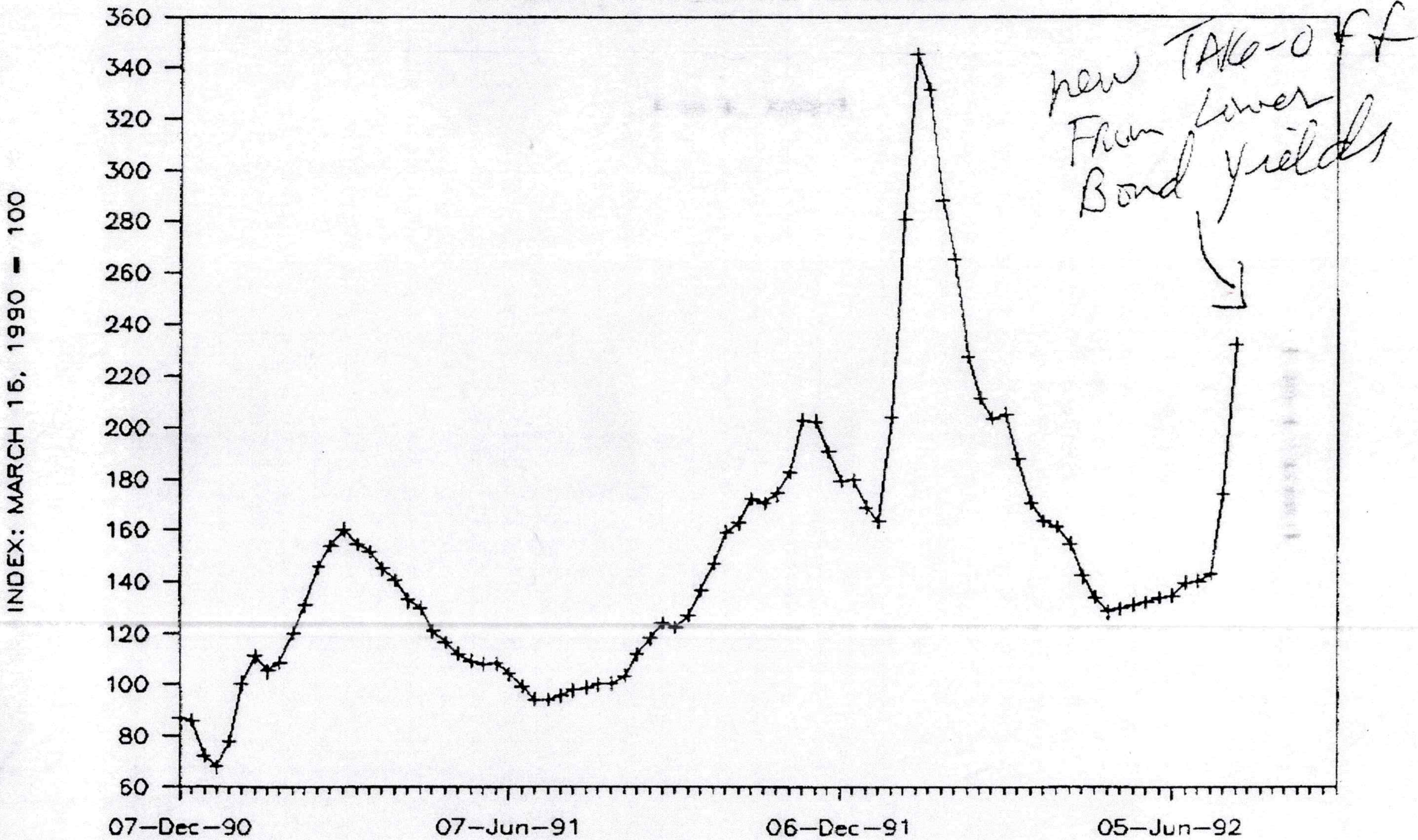
There are very few Americans outside of Washington who believe that our tax burden is too low, very few. From my own supply-side views on the disincentive effects of taxation, I oppose any tax-increase measures. But a balanced budget amendment can be structured which, over a five-to-seven or even ten-year period, changes the current services accounting structure, reinstates presidential impoundment authority, reduces and eliminates non-essential, low priority programs and essentially freezes the overall budget to some formula increase for entitlement control (be it inflation plus population growth or what have you). If such an agreement can be structured without any tax hikes, then I absolutely favor that kind of balanced budget amendment.

The issue here again is economic growth. How to get the US economy to grow at 4% in the next five years, which by itself would improve the budget situation by lowering unemployment and increasing jobs and productivity and capital formation? I am a strong supporter of fiscal rules. I agree with the work of Nobel Prize winner James Buchanan and other distinguished free-market economists, whose views are being copied all over the world. In Russia, in Czechoslovakia, in Hungary, in Mexico, in Argentina, in Southeast Asia, in China, the notion of raising incentives through low tax-rates, the notion of free market productivity, the notion of limited government interference are global themes. If the United States can adopt that in its rule-making, I think it is terrific, and I am all for it.

So I can support a theoretical amendment on this as long as it is geared towards economic growth, spending restraint, and government downsizing. However, I cannot support an amendment which either specifies or implies a sharp increase in tax rates, and no fundamental reforms or restructuring of the government. I dare say, the American public probably feels similar disposed if one judges from the polls.

MORTGAGE APPLICATION VOLUME INDEX

FOR BOTH PURCHASES AND REFINANCING



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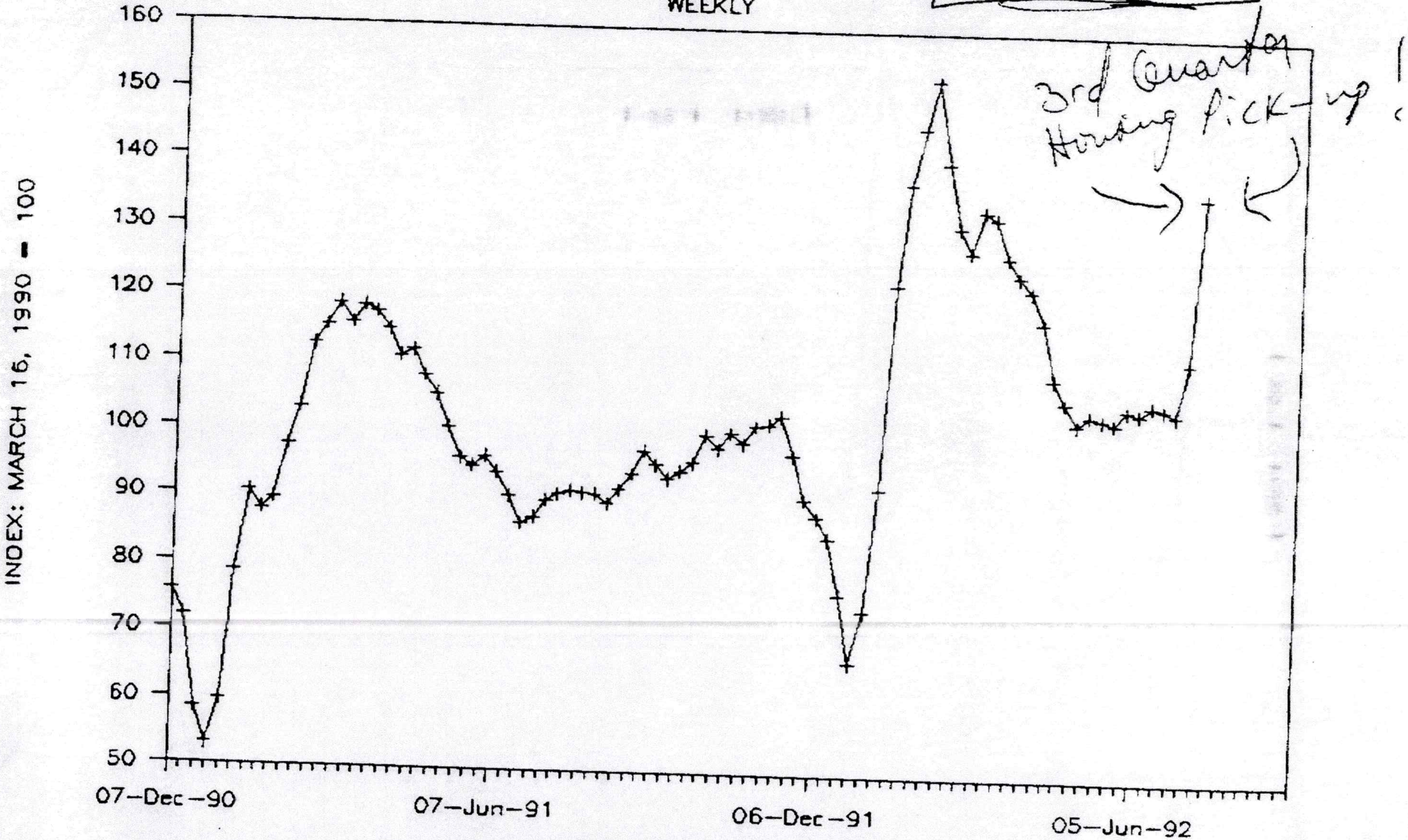
MORTGAGE APPLICATION INDEX: PURCHASES

WEEKLY



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MORTGAGE APPLICATION INDEX: REFINANCING

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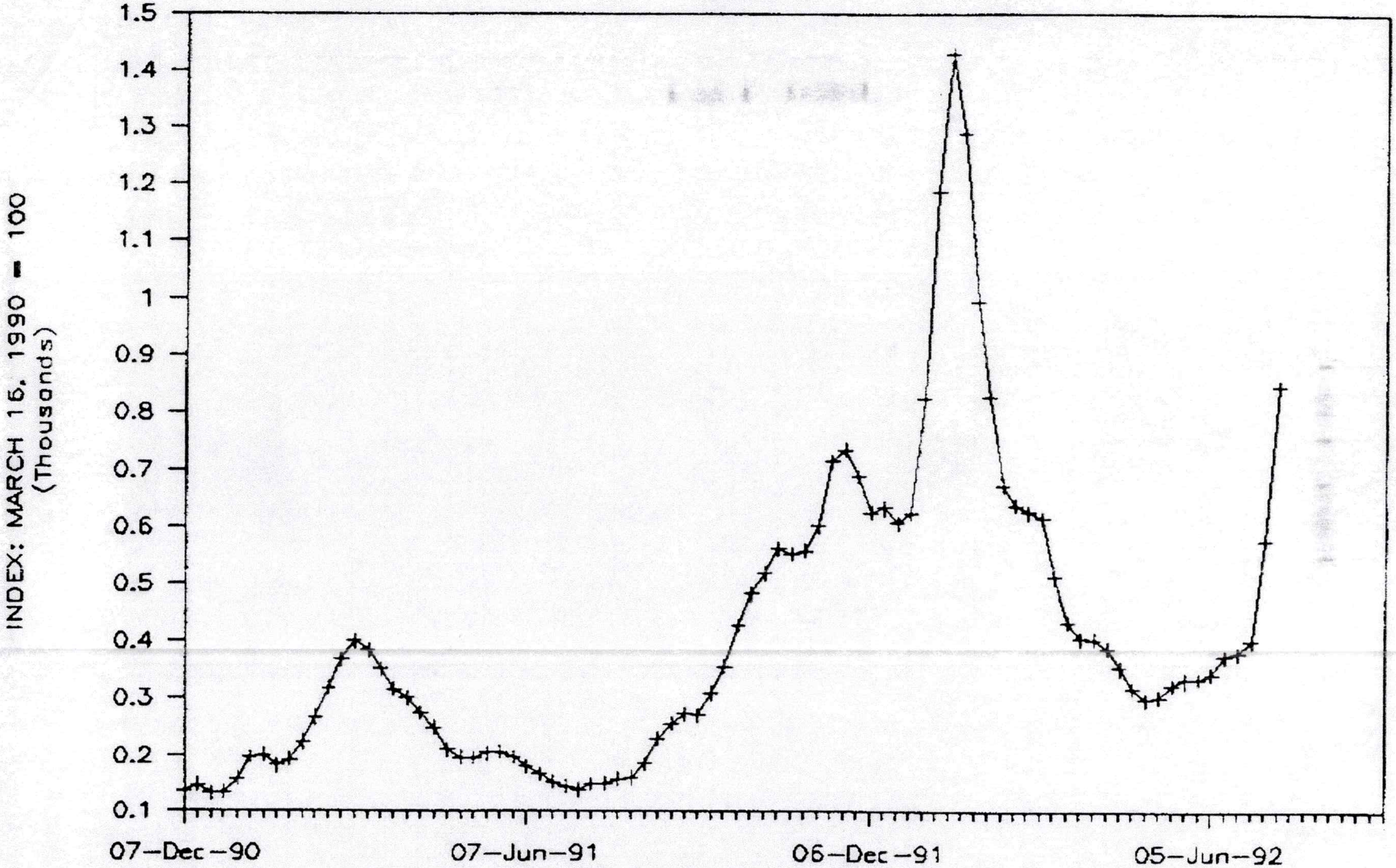

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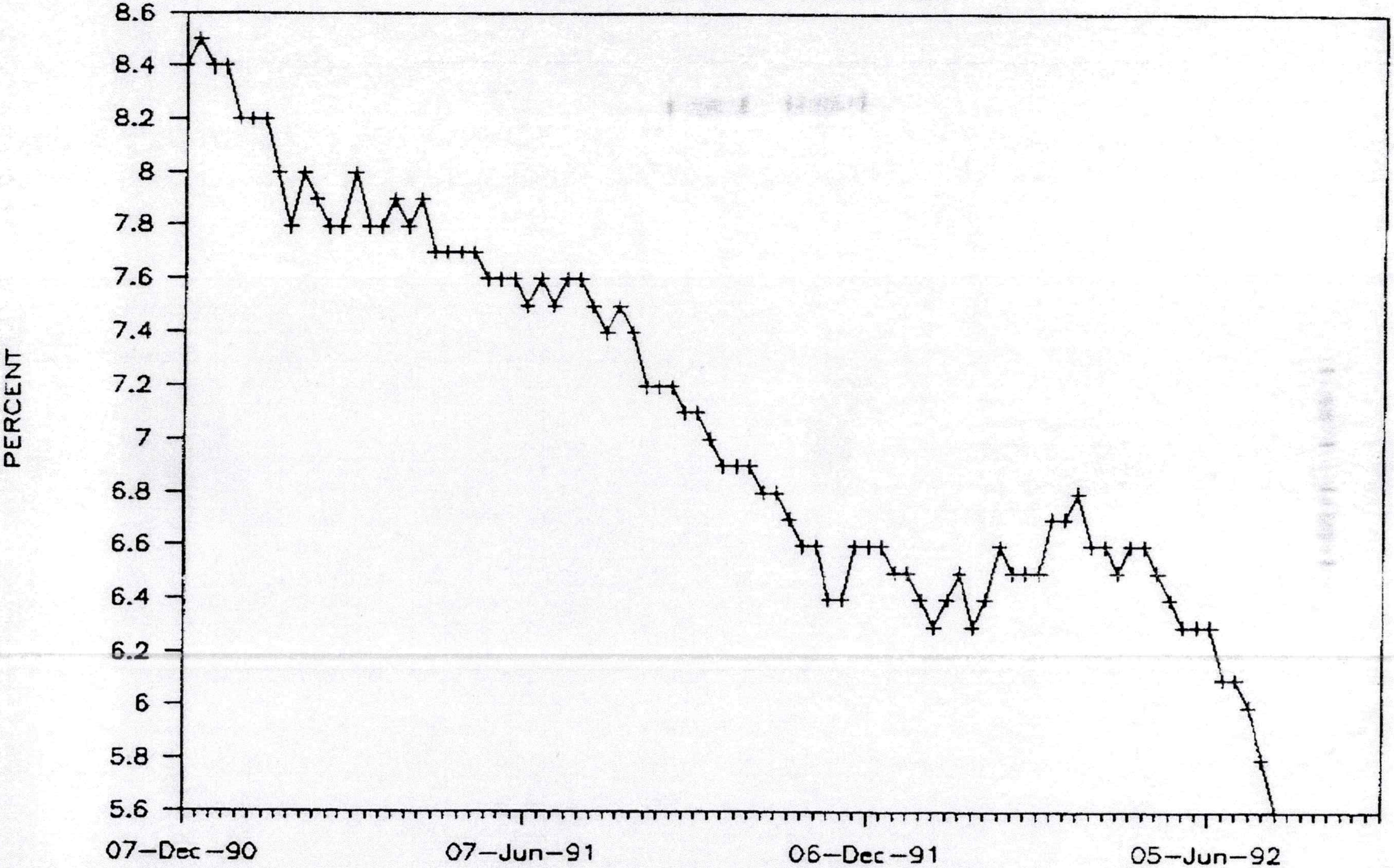
1-YEAR ADJUSTABLE RATE MORTGAGE

WEEKLY AVERAGE EFFECTIVE RATE



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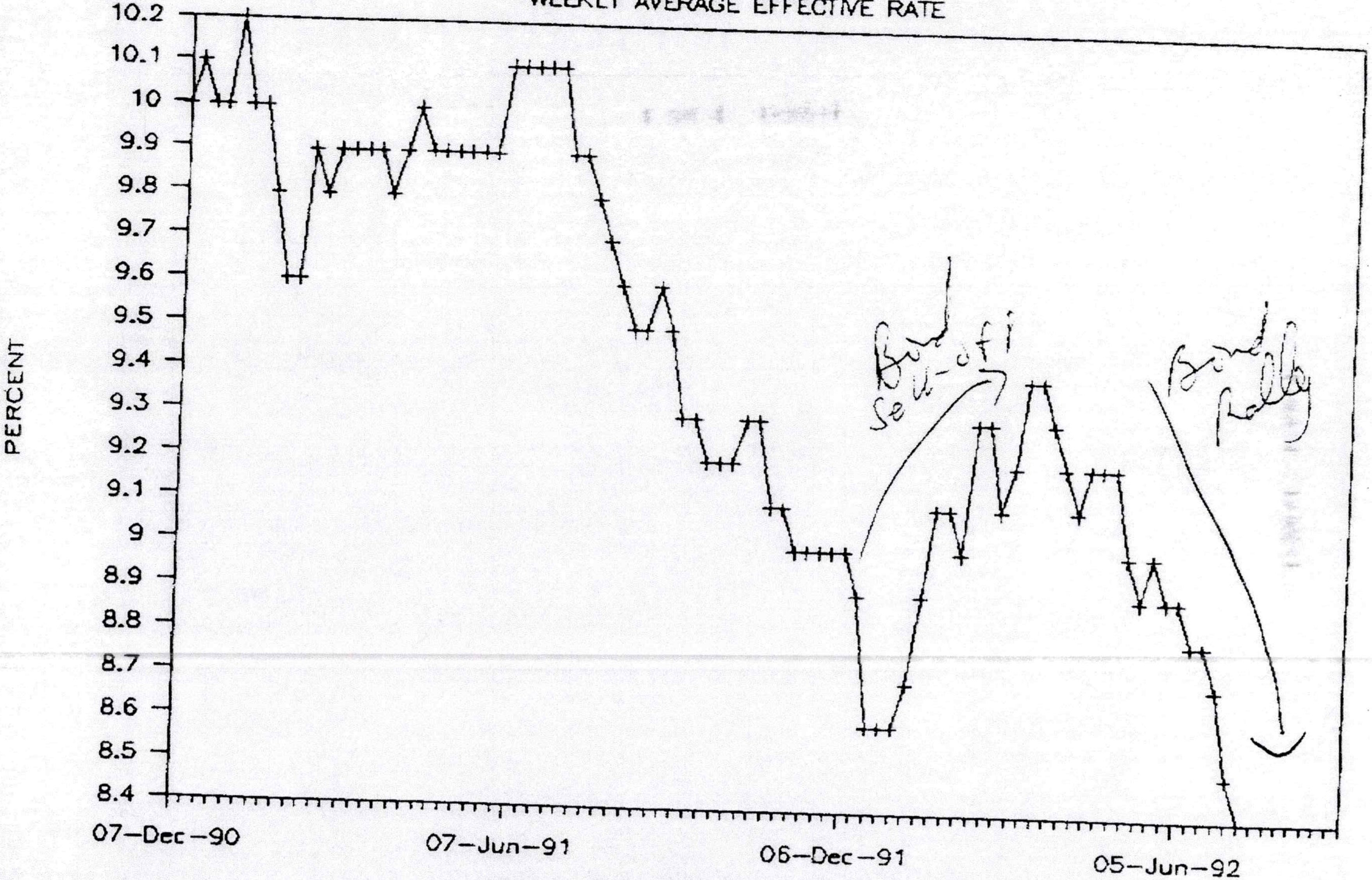
30-YEAR FIXED RATE MORTGAGE

WEEKLY AVERAGE EFFECTIVE RATE



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Focus on Growth, Not Short Rates

By LAWRENCE A. KUDLOW

PRESIDENT BUSH may be right about the need for lower interest rates, but jawboning the Federal Reserve as he did last week could actually undermine his goal of more rapid economic growth. The public needs pro-growth fiscal policies from the President much more than another small decline in short-term interest rates. The Fed has already tamed inflation. Giving in to political pressure now could jeopardize this achievement and the recovery as well.

Understanding why requires a look at how short-term and long-term interest rates have been heading in opposite directions. The President asked the Fed to lower short-term rates, which it can control by adding or draining the money banks hold as reserves. Short-term rates have fallen by 4 percentage points over the past 20 months to below 4 percent, or near their 30-year lows.

But long-term rates have risen about three-tenths of 1 percentage point since January. These rates, reflecting investors' expectations of inflation, have a more powerful influence on the economy. They have remained stubbornly high, near 8 percent, slowing the recovery in business investment and housing.

Lawrence A. Kudlow, a former economic adviser to President Reagan, is chief economist at Bear, Stearns & Compan :

Paradoxically, if the Fed pushes short rates down too far, creating an overdose of new money, then long-term rates would actually rise from renewed inflation fears. This is a risk the President ought to consider, for another spike in long-term rates might well abort a recovery that is already slower than usual.

Lower short-term rates would also reduce global demand for dollars, as investors buy other currencies offering higher returns. The dollar's purchasing power and hence the inflation outlook depend on the willingness of people to hold it. If no one wants it, its value plummets, causing prices and interest rates to rise. The exchange rate has already fallen by 13 percent over the past year, an inflationary omen.

Some of the President's advisers are probably telling him that the money supply is growing too slowly. M2, the most closely watched indicator, which includes most bank deposits and money-market funds, has risen by less than 2 percent over the past 12 months. But other money supply and bank reserve measures indicate growth rates of 8 percent to 16 percent.

If the President were communicating more closely with the Federal Reserve board, he would know that Greenspan & Co. have developed a new approach to balancing money supply and demand. They use inflation-sensitive market indicators — including such commodity indexes as the price of gold — to determine whether the balance is deflationary, inflationary or just right.

Their approach makes plenty of sense. In our global, high-speed markets, prices immediately change to reflect all the available information. Every nanosecond, the world market price of gold contains more information and wisdom than all the computer models used by the Council of Economic Advisers.

An overdose of new money could renew inflation fears and lead to higher long-term rates.

In the past two years, Fed policies have stabilized the gold price in a narrow band around $350 an ounce, while broader commodity indexes have also remained steady. These indicators confirm the Fed's progress against inflation.

The producer price index has increased by only 1.1 percent over the past 12 months, the consumer price index by 3 percent. Only two years ago, these inflation measures were at 6.5 percent to 7 percent.

BY politicizing election-year monetary policy, the President may well create more uncertainty, keeping long-term rates sticky despite the progress on inflation. If he truly wants to improve the prospects for growth, he should endorse the Fed's Bretton Woods-style effort to restrain inflation and make the dollar as good as gold.

Then he should pursue his own growth program, with enterprise zones, a reduction in the capital gains tax, a spending freeze and a middle-income tax cut. These measures could take the economy from about 2.5 percent growth now to 3.5 or 4 percent next year without renewed inflation. This would be a winning economic policy for the Bush Administration in November. ■

TRANSMISSION SHEET

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