April 26, 1982

George P.

TO: Senator Dole

FROM: George Pieler

SUBJECT: International Auto Dealers Speech

Attached is an Outline of Remarks for the American International Automobile Dealers seminar. In addition, the AIADA expressed an interest in the following trade issues (following information supplied by the trade staff):

(1) Local content (or "domestic content") legislation:

Legislation has been introduced and referred to the Commerce Committee that would require that up to 90% of the cars sold in the United States must be made in the U.S. The percentage requirement for U.S.-made cars declines as low as 60%, depending on the sales volume of the auto manufacturer. The goal is not just to limit sales of foreign cars but to discourage U.S. automakers from locating production facilities overseas. The percentage limits would be phased in over three years beginning in 1983, to allow time for adjustments.

- Obviously the legislation is of concern to dealers in imported cars, because it could drastically limit their sales volume.

- The bill has 11 cosponsors (Senator Lugar is the only Republican). Companion House bill has 188 cosponsors.

- The administration will oppose the legislation, and there is no immediate sign of movement on the proposal.

- A few other major trading companies have similar rules (Australia, Spain), but such "local content" rules generally are regarded with extreme disfavor by the trade community as being unreasonable infringements on trade.

- While the Finance Committee has no direct role with regard to the legislation, the trade staff is monitoring the bill.

(2) Reciprocity

The Danforth and Heinz bills (both of which you cosponsor) provide an explicit "cause of action" under section 301 of the 1974 Trade Act for denial of reciprocal market access. To redress a complaint that is upheld by USTR, the President may impose barriers

OUTLINE OF REMARKS

AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION

April 27, 1982 - 12:30 p.m. - L'Enfant Plaza Hotel - Wash D.C.

I. The Economic Recovery Program

A. Sticking to Fundamentals

1. Concerns about threatened deficits are very real and justifiable. But those deficits are not a result of the Reagan program, which is fundamentally sound--we must follow through on its principles of spending reduction, lower taxes to restore economic incentive, a firm but fair monetary policy, and a strong defense.

2. We can act to cut the deficit without undermining the recovery program or putting additional 'drag' on the economy during the recession. We are aiming at sustaining recovery after the recession: that is what the debate is all about. No one seriously advocates tax increases or other fiscal tightening during the recession.

3. Significant progress is being made on the economy. Inflation in 1981 dropped to 8.9%, the lowest since 1977. Producer prices dropped in February and March, and in March the CPI declined by 0.3%--the first such decline since 1965, and the largest drop since 1953. This is dramatic progress on what everyone considered to be our number one economic problem.

4. At the same time, while interest rates remain much too high, they have come down, and there is reason to expect a steady downward trend with a few fluctuations. 16 1/2% is better than 21%. Cooperation between the President and Congress will help bring rates down, by showing a consistent, firm course: to bring deficits down, keep spending under control, and pursuing tax policies that encourage work, savings, and investment.

B. The Recession

1. The recession is the reason why we need to make adjustments: it has driven down revenues promptly (lower inflation, slower growth) but has a lagged effect on slowing some spending, while in the short term unemployment and other costs rise.

2. In 1980 the Carter administration tried to prime the pump after experimenting with monetary restraint--

the subsequent clampdown proved that the 'recovery' from that recession was a false one. Only now are the full effects of the (now-resumed) recession being felt. The important thing this time is to ensure a real, sustained recovery.

3. Compounding our difficulties are long-term problems in autos and housing, partly induced by the rampant inflation of recent years and partly due to inconsistent policies on energy, taxes, and productivity. The Reagan administration is working full time to deal with these underlying problems, and progress is being made. We are seeing hard bargaining between labor and management in the auto industry that may bode well for a more rational industrial policy.

4. Major shifts in policy are bound to bring instability as we make the transition--particularly when we are moving out of a period of double-digit inflation. But we must make the transition, for the only alternative is inflation and stagnation. We must improve our chances for stable growth by acting swiftly to control projected budget deficits.

II. Time is Short

A. Congress

1. Congress cannot evade the fact that it is the source of the main problem--the uncontrolled growth of Federal spending in recent years. That spending momentum, aggravated by inflation and recession, is the cause of the expected deficits.

2. The deficit problem needs immediate action, and there may not be that many opportunities to deal with it. At least we must enact a deficit-reduction package before we are obliged to raise the debt ceiling again. That means action by summer if we are to avoid political stalemate.

3. Progress has been made, and there is widespread sentiment that we need a package that tackles all aspects of the budget problem: appropriations, entitlements, defense, and revenues. A deficit reduction package must be balanced and fair.

4. Congress is obliged to suggest concrete alternatives if it does not want the President's budget. But it cannot do the job alone.

B. The President

- The President's 1983 budget reduces the deficit, but lacks support because it is open to the charge that it does not share the burden of deficit reduction in an equitable way.

2. Even those who disagree with the President must admit that we need to reduce the deficit by at least as much as the President recommends: over $40 bilion in spending cuts and management changes in FY 1983, and over $30 billion additional revenue over two years.

3. The President has made clear his understanding that he will have to deal with Congress if we are to get action on the deficit. He is right to stress firmness on the fundamentals of his program. But there are many ways to increase revenues, deal with entitlements and appropriations, and moderate defense spending without sacrificing those fundamentals. There is a margin for compromise available, but it must be taken advantage of before it disappears.

4. The President indicates a willingness to give us room to run. We cannot have ultimatums on either side--we need flexibility. Not because we disagree with the President's aims--but because we have to be realistic about how much we can achieve this year, consistent with the essential goal of getting the deficit down.

III. Policy Options

A. Basic Principles.

1. There are many ways we can attack the deficit problem, but there is no way to do it unless we have some parameters--some guidelines. The sooner we narrow the range of options, the better.

2. One thing we must not do is allow the need for some revenue increases to be an excuse to uncork the spending bottle. Too often Congress has shown deficits are not cut by tax increases, because Congress always spends more. That cannot be allowed to happen.

3. Along the same lines, the individual tax cut ought to be out of bounds: it is mainly an offset for bracket creep in any event, and we do not need further resort to the inflation tax as a budget device.

4. Defense spending must increase, but perhaps it can increase at a slower pace, by balancing our must urgent defense need against long-term priorities.

5. Spending must be brought down--there is no other way to get a handle on the deficit. That means entitlements and so-called uncontrollables have to play a role.

B. Revenues.

1. There are several ways to proceed: the President proposed management changes, user fees, and some loophole closings. All of those will play a role, and they should in the interest of ensuring everyone pays a fair share of taxes.

2. Likely candidates for action include corporate and individual minimum taxes, reductions in the safe harbor leasing provision of the 1981 tax act, and efforts to narrow the compliance gap in the income tax--as in the Dole-Grassley bill, S. 2198.

3. Another option, consistent with the goals of individual rate reductions enacted last year, would be to accelerate tax indexing to July 1, 1983, in place of the 1983 rate cut. Lower inflation means less rate reduction than we anticipated is needed to offset bracket creep. If the inflation trend continues, this option could bring marginal rates to about where they were expected to be when we passed the tax bill, yet raise about $17 billion over two years.

C. Entitlements.

1. Reform of basic entitlement programs is needed to bring the budget in line. Administration proposals for 1983 would save about $52 billion over 3 years. We should try to meet or exceed that figure.

2. Partly due to cost-of-living adjustments, entitlements (other than social security) rose 412% between 1970 and 1981. We cannot sustain that kind of growth.

3. As an example, Medicare is expected to cost $50 billion in 1982, and Medicaid $32.5 billion. Hospital cost rose 18.6% between October 1980 and October 1981. We cannot afford this rate of increase, and must consider reforming

reimbursements, more private sector options, and greater competition in the health care industry.

4. COLA's must be reconsidered, even in the social security area. In the 1970's social security cash benefits grew at a pace of 14.2% each year. That is cause for concern. Real savings can be made consistent with keeping social security recipients on a par with wage earners in our society. For example, moving to a 2/3 CPI adjustment could save as much as $5.4 billion in 1983, $50 billion by 1986.

IV. Some Perspective on Our Situation

A. A Growing Economy

1. By 1986 the administration expects the economy to grow from $2.8 trillion to $4.6 trillion. Such growth means a better ability to finance our defense needs and critical social programs, without taxing the life out of the economy.

2. If we have slower growth, then we have to reexamine our options. CBO and the administration are in basic agreement on economic trends: this is the time to strike a prudent, but optimistic, balance. But clearly $100 billion deficits are unacceptable, economically or politically.

B. 1981 Tax Act and the Deficit

1. The 1981 Tax Act, though the largest tax cut in history, just stabilizes the tax burden. Revenues still will rise from about $600 billion in 1981 to about $800 billion in 1985. Receipts by 1987 should be 18.7% of GNP - the same as the average between 1963 and 1973. Without action, receipts would have been a crushing 24% of GNP in 1987.

2. The question is how high a deficit can be tolerated without "crowding out" or threatening a resurgence of inflation. Increased savings due to tax changes and the drop in inflation should ease pressure in financial markets. We must do more to ease that pressure without undermining the economic program.

3. Many provisions of the tax act aid capital formation and innovation: R & D tax credits, capital gains reduction to 20%, IRA and other savings incentives. These coupled with rate cuts and accelerated depreciation, form the framework for regeneration of business activity.

V. Future Agenda for Tax and Fiscal Policy

A. Revenues

1. Thrust of future tax legislation will be to eliminate abuses and obsolete incentives and improve tax administration and collection. The 1981 Tax Act shows this trend, as in closing the commodity straddle loophole.

2. The administration proposes raising over $30 billion over 2 years by tightening in these areas, and by new enforcement devices. Depending on the size of spending cuts we can agree to, Congress may want to increase this figure.

   - Completed contract method for multiyear defense contracts. ($6.3 billion over 2 years.)

   - Cut back business credits that duplicate conservation efforts of decontrol ($.4 billion over two years). (Congress is not sympathetic to this.

   - Industrial development bonds (restrict, require matching efforts from State or locality, etc.) ($0.1 billion over two years).

   - Eliminate insurance industry loophole (modified coinsurance). ($4.1 billion over two years).

   - Capitalization of construction period interest and taxes. ($1.5 billion over two years).

3. Underground Economy

   a. The Compliance Gap

      The IRS estimates that $100 billion is lost annually though noncompliance with the federal income tax laws and that amount will rise to $133 billion by 1985.

   b. The Proposal

      S. 2198, the Dole-Grassley bill, would improve the current system of information reporting. A companion bill has been introduced in the House by Representative Barber Conable. 9 to 16% of interest and dividends paid go unreported. We can improve the reporting system by including federal debt and bearer obligations and impose real penalties on those who refuse to comply.

c. The Administration

The administration has proposed 5% withholding -- an option that we cannot rule out, but that has been unpopular. All aspects of noncompliance, including, for example, underreporting of tips and capital gains, may be addressed by better information reporting. The administration supported S. 2198 at hearings held on March 22.

d. Coverage

In addition, new penalties would hit the sophisticated tax avoider and the fraudulent corporate tax manager. The interest rules would be revised to reduce current incentives to defer paying taxes.

e. Revenue Effect

The legislation is expected to generate about $3 billion in 1983, $8.1 billion in 1984, and $9.3 billion in 1985.

4. Minimum Tax

a. Current Law

Current law includes three very complex minimum taxes, two on individuals and one on corporations. These taxes raise only $1.5 billion and still permit significant numbers of taxpayers to pay no tax.

b. Administration Proposal

The Administration would address this problem by creating a new alternative minimum tax on corporations. This would raise about $2.3 billion in the first year, rising to the $4 billion range.

c. The Dole Proposal

The proposal being considered would completely revise and simplify the minimum taxes. In lieu of the overlapping alternative and add-on taxes on preference items, the minimum taxes on corporations and individuals would be a flat rate of, perhaps 15% on a comprehensive, economic income base.

d. The Tax Base: Individuals

Included in the tax base for individuals might be adjusted gross income and items like excess accelerated deductions, contributions to IRA's and Keoghs, the stock option preference, intangible drilling costs, certain excluded items and other items.

e. Corporations

Corporations' tax base will begin with taxable income and addback similar preference items of accelerated depreciation, certain deferred income, and excluded items. Of particular interest to banks is a rule which disallows interest deductions to the extent that tax-exempt instruments are included in a bank's investment portfolio.

f. The minimum tax is fully consistent with the 1981 tax cut. That tax cut provided incentives by reducing marginal tax rates. The marginal tax rate of a minimum tax will only be 15%: all taxpayers with substantial real income ought to pay some income tax.

g. Revenue Effect

The proposal is tentatively expected to produce approximately $2 billion annually from the individual tax and $6 billion annually from the corporate tax.

5. Leasing

a. Some revenues may be generated by cutting back on the safe-harbor leasing provisions of the 1981 Tax Act. Those provisions are now expected to cost about $30 billion over six years, find the figure may go higher when Treasury analyzes its reports on leasing transactions.

b. Possible options, aside from outright repeal, include offsets in other tax preferences, application of strengthened minimum tax, or direct limits on tax sheltering.

C. Social Security

1. We have restored the minimum benefit and authorized temporary interfund borrowing. Now the President's Task Force, chaired by Alan Greenspan, is preparing to address the long-term problems of social security. Some action may be necessary <u>before</u> the Task Force completes its work.

2. Only if the economy performs considerably <u>better</u> than in the past 5 years could social security remain solvent beyond 1984 or 1985. Even then:

   - Under the most recent projections by the Social Security Board of Trustees, the combined reserves of the system fall dangerously low (below 14 percent of outlays) in 1985. The system would be unable to pay benefits beyond 1987 (when reserves fall below 9 percent of outlays).

   - Under more pessimistic economic assumptions -- more like recent experience -- social security would be broke by late 1983.

3. The trust funds already are seriously depleted -- reserves equal 23 percent of outlays or barely 2 to 3 months' worth of benefit payments. The history of the trust funds indicates that reserves equal to <u>100 percent or more</u> were the norm prior to 1970.

4. Further tax increases, beyond those legislated in 1977, are not the solution. The long-term cost of social security must be brought into line with taxpayers' willingness and ability to pay for it.

V. Enterprise Zones

1. The President also wants to establish enterprise zones to benefit from targeted tax incentives and, hopefully, Federal, State, and local regulatory relief. The notion of unleashing free enterprise makes sense: but there are difficulties.

2. There is a risk that zones may put businesses outside the zone at a competitive disadvantage. We

do not want to drain business activity from the periphery of zones.

3. Shifting economic resources around would not be enough. We ought to have some assurance that <u>new</u> activity is likely to be generated.

4. The selection of zones -- if limited to 25 per year for three years, as proposed -- will be a touchy matter. If it is to have any meaning, this should be an experiment in free enterprise, not a new pork barrel.

5. The President's proposal includes a new 10% investment tax credit for construction or rehabilitation of commercial, industrial, or rental housing structures within a zone. This could help meet housing and commercial needs in depressed areas.

6. Primary emphasis must remain on the general economic growth we need to create jobs across the land.

VI. <u>Summary--Where We Are Now</u>

A. <u>A Watershed Year.</u> The recession makes this a tough year <u>for Congress and</u> the President. There are <u>no</u> easy or palatable options available. That means we have to establish our priorities swiftly but with care: not an easy task. But if we show that we can work together to deal <u>now</u> with problems that have been building over many years, we will have a <u>major</u> breakthrough in favor of economic recovery.

B. <u>Shared Effort.</u> The economic problem can only be addressed by a joint effort all around--Congress and the President, Democrats and Republicans. Those who would seek partisan advantage from our economic dilemma are mistaken. If we hang, we all hang together, regardless of party. The people will not care who prevented action, if nothing is done. What we need is results.

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to the U.S. market for traders or investors of the country found to be at fault. For example, if the Japanese were found to be denying U.S. car manufacturers access to the Japanese market substantially equivalent to that offered by the U.S. to the Japanese, the President could seek ways to restrict Japanese access to the U.S. auto market.

- The international auto dealers oppose reciprocity, think the term is too vague, and do not want to start a conflict with Japan on auto imports.

- The International Trade Subcommittee has held hearings, and more are scheduled for the first week in May.

- Reciprocity legislation is under consideration, and would be approved, only because there is a perception that there is a lack of fair play that may be costing the U.S. jobs. To the extent that concern can be addressed by voluntary understandings, the need for spelling out reciprocity by statute becomes less. There is no desire to limit the options available to consumers in a free market, just to be assured that the market really is free all around.

(3) Taxes/Quotas

There are several proposals to deal with auto imports through tax penalties or quotas. Riegle and Levin have introduced a bill to impose a tax on imports equivalent to the 'nontariff barrier costs' deemed to be imposed by the the source country on U.S. exported cars. Another bill would impose a direct quota on Japanese imports for the next three years, in an amount equal to 14% of the projected domestic market growth.

Senator Quayle also has a bill to provide a tax credit of $750 to the purchase of an American-made car or truck.