OUTLINE OF REMARKS

PHILIP MORRIS CORPORATE AFFAIRS

July 20, 1983--6-8 p.m.--Four Seansons

I. The President and the Congress

A. President Reagan knows that he and the 98th Congress need to deal with a number of pressing problems, but at the same time he is putting firm limits on possible areas of compromise. We have had constructive action on social security. But the deficit urgently needs to be dealt with. As we proceed we should not compromise away the gains won towards restraining the growth of spending, controlling the tax burden, and beating back inflation. The American people still overwhelmingly support those goals.

B. The President still sets the agenda. On taxes, spending, deficits, employment, and trade the President proposes, and Congress must dispose. Those of us who have ideas of our own will work with the White House to get things done--but leadership still must come from the President. That is why we are unlikely to see any major departure from the principles of government Ronald Reagan has espoused in his first two years in office.

C. The fact remains that there is no coherent alternative to Republican leadership. The people still recognize that our economic problems were a long time in the making, and that the cure will take time too. According to CBS/New York Times voter exit polls in the last election, voters by a 5 to 4 margin blamed our economic problems on past Democratic policies rather than on President Reagan.

II. The Economy

A. Prognosis. We have to realistically assess the state of the economy and the prospects for the next few years. Recovery is well under way, and the groundwork has been laid for a stable and lasting growth well under way without renewed inflation. It is absolutely crucial that we proceed with care at this point, and not throw away the gains already made.

No one should doubt that we are making progress. The "flash" GNP indicator for the second quarter of 1983 shows growth at a 6.6 percent rate. The index of leading economic indicators has jumped 11 months in a row. Industrial output rose 2.1 percent in April; the highest monthly rise in 8 years, and 1.1 percent in May. Economists agree we are in a broad based recovery.

1. Inflation was cut to 3.9 percent in 1982, from 12.4 percent in 1980. This is the lowest inflation rate since 1972. And the trend is continuing: consumer prices rose less in the first quarter of 1983 than in any quarter since 1965. The 0.6 percent rise in the April CPI was largely due to the gas tax increase and bad weather boosting food prices.

2. Interest rates are down. The prime rate is at 10 1/2 percent, way down from the 21 percent that prevailed when President Reagan took office. Home mortgage rates are down since last year. Long-term rates for business loans are off about 3 points from a year ago.

3. Lower taxes with major improvements in tax equity will help buoy the recovery, both on the consumer side and on the investment side. The combined effect of the 1981 and 1982 tax bills has been to lower individual taxes over 3 years by $344 billion, as well as improve compliance and tax fairness. Lower individual rates boost personal income and restore incentive, while favorable capital cost recovery rules should spur investment.

4. Housing starts are up at a 1.8 million annual rate, the highest in 3 years; the stock market is up over 400 points since last August; car sales are at a 7.3 million rate. These are tangible evidence of recovery. Consumer confidence is rising; retail sales rose 1.6 percent in March, 1.7 percent in April, and 2.1 percent in May, and auto sales were up 5.2 percent in the first 10 days in May. Inventories have been cut to their lowest levels in 2 years, and have begun to rise again.

B. Unemployment. The January drop in unemployment to 10.4 percent was followed by further declines down to 10.0 percent in June, and the number of jobs rose 1.2 million in June. Unemployment, of course, remains the major negative in the economic picture. High unemployment has to come down and stay down without inflationary stimulus--that is what we have failed to do in the past. Since January, employment is up 4 1/2 million.

o Clearly there is a bipartisan consensus for more jobs. But resuming the inflationary policies of the past will not create lasting jobs, just an illusion of prosperity that leaves us worse off the next time we try to get "off the wagon."

o That means the most important thing we must do is judge carefully the degree of stimulus the economy can and should take, consistent with a firm anti-inflation policy. The Federal Reserve will play a key role, and has already shown a willingness to adjust its short-term goals based on its assessment of the economy. We will not allow the recession to continue, but we will not reinflate the economy, either.

In addition, constructive steps have been taken:

- A new Federal supplemental unemployment compensation program was passed with the 1982 tax bill, providing additional unemployment benefits to well over 2 million workers. This program will extend through September 30.

- The new Job Training Partnership Act emphasizes training for permanent employment rather than make-work jobs.

- The targeted jobs tax credit, which was extended for 2 years by the 1982 tax bill, gives employers an incentive to hire the disadvantaged--about 600,000 workers are certified under the program.

- The administration's enterprise zone legislation, just approved by the Senate, can provide us with an experiment in private-sector job creation in depressed areas, through a combination of Federal tax incentives and State and local efforts to target an area for development with regulatory and tax relief, neighborhood participation, and capital and other improvements.

C. The Deficit and Interest Rates.

1. All our economic difficulties are, of course, related--high interest rates and slow growth boost the deficit, and higher deficits create greater uncertainty in the business community as to our future course; will there be more inflation, or less credit available for business expansion?

2. Because of this, it makes sense first of all to chart a path that is most likely to bring stable growth without inflation. Higher growth boosts revenues and cuts unemployment costs, thereby reducing the deficit as well: already, upward revisions of growth estimates are being made in light of our economic progress and indications of further improvements.

3. Continued efforts to restrain the deficit by controlling Federal spending will give the Federal Reserve a bit more room to accommodate the potential for real growth that exists in the economy without inflationary pump-priming. But restraint in both fiscal and monetary policy is crucial if we want to maintain long-term confidence in the economic program. The reappointment of Chairman Volcker at the Federal Reserve is a good move towards maintaining public confidence.

III. The Budget Resolution

A. Conference Agreement. The conferees on the budget resolution tried hard to reach a reasonable agreement, but it is not clear that the result is the best way to reduce the deficit, or even that it will bring significant deficit reduction. Of the proposed deficit-reduction measures, 88 percent is within the jurisdiction of the Finance Committee--and 86 percent is due to proposed tax increases, not to spending restraint. The resolution proposes a $73 billion tax increase over three years, $12 billion in 1984, $15 billion in 1985, and $46 billion in 1986. In addition, the reporting date of July 22 is totally unrealistic.

B. Real Choices. Because so much in the way of spending programs is left out-of-bounds, the real choice proposed for us is to raise taxes or accept for now the high deficits that result from our spending decisions. That is not an agreeable choice to make, particularly when the conferees are proposing a so-called "contingency fund" to allow for new spending if Congress decides it is needed--to the tune of $8.5 billion. In addition, this puts the Budget Committee in the position of determining specific spending policies, not just overall targets.

C. Implementation. One relevant question in evaluating the budget agreement is whether the votes exist to implement it. Many members who supported the resolution might not be as willing to vote for the tax increases needed to implement the conference agreement. If so, it does not help financial markets to propose a resolution that will not be acted on in any event.

D. Domestic spending. While we cannot let the burden of deficit reduction fall on benefits for lower-income Americans, we should not assume that domestic spending is untouchable. Even the budget conferees agree that, for example, Medicare is a proper source for savings. Certainly we have to acknowledge that Federal health program costs are out ot control, and that changes are very much in order. (The resolution proposes about $1.7 billion in Medicare savings). If the contingency fund is included, domestic spending would be up $10 billion next year.

E. Even if we fail to implement the resolution, that does not mean the fight against the deficit is over. The President will use his veto to try to keep spending in line, and he has a lot of supporters who will help him sustain those vetoes. In many areas hand-to-hand combat over specific programs may achieve more real results.

IV. Taxes: Third Year and Indexing

A. The President has said time and time again that he will fight to retain the third year of his tax cut and indexing, and many of us will continue to support him, even if a veto is required. Thirty-four Senate Republicans and 146 House Republicans have signed letters to that effect. The reasons are quite simple: these measures are good for the economy, they are fair, and they give long-needed real tax relief to the hard-pressed middle income American.

B. Third year. Why is the third year important? First, most economists agree that the timing of this last stage of President Reagan's individual tax program is excellent in terms of giving the economy a boost on the consumption side as we emerge from recession. This is a sharp contrast with the past, when tax changes to counter recession were too little and too late.

Equally important, the third year is needed in the interest of fairness. Only the third year gives a full measure of tax relief to working people. For taxpayers with incomes $10,000 or less, repeal of the third year means a tax increase averaging 13.9 percent. For those between $20,000 and $30,000 in income it means a 12 percent jump in taxes. 72 percent of the benefit goes to Americans making $50,000 or less.

In dollar terms, repealing the third year would cost a taxpayer at $15,000 income $112 in FY 1984; at $20,000 income, it would cost $203 in 1984; at $30,000 income, taxes would be $410 higher in 1984.

C. Indexing. Indexing is crucial not just because it provides tax relief, but because it insures truth in government: tax changes will have to be voted on openly and directly, rather than having Congress rely on inflation to raise revenues through the deception of bracket creep. Whatever attitude you take on the question of generating new revenues, it makes sense to keep indexing in place.

In addition, indexing is an important symbol of our commitment to fight inflation. Repealing it only generates significant revenues if you assume inflation will persist at fairly high levels. If we de-index, we send a signal that we are not committed to beating inflation--and that means bad news for financial markets, for interest rates, and for consumers and investors alike.

Finally, the tax relief provided by indexing is real and sustained. Indexing means $98 billion in tax relief between 1985 and 1988, assuming modest inflation. $78 billion of that goes to taxpayers earning under $50,000. This group now pays about 66 percent of taxes, but will get 80 percent of the benefit--proving that indexing is a truly progressive tax reform.

A median income family of four would pay $1,000 in additional taxes between 1985 and 1988 if indexing were repealed (assuming they earn $24,000 in 1982). Remember that consumers are homebuyers as well, and their after-tax income is as important as interest rates in determining whether they will buy.

V. Issues of Continuing Concern

A number of issues that have been around for some time may receive attention from the 98th Congress.

1. 6-month holding period. Efforts to reduce the capital gains holding period to 6 months will continue. There is very strong support for this change, because it can give a boost to capital markets at a time when greater savings and investment is vitally important to sustained economic recovery. This change was approved by the House in 1981 and by the Senate on three

separate occasions in 1982, so it is time to get it enacted into law.

2. Enterprise Zones. The Senate has approved a modified version of the administration's enterprise zone proposal. A major question remains whether the House will take an interest in the idea, which they did not in the 97th Congress: but at least the Senate action, as part of the withholding repeal package, will get the attention of the House.

3. DISC. While no specific DISC proposal was made in the 97th Congress, the issue was extensively discussed--particularly the question of legality under the GATT. The Administration has committed itself to bringing the DISC into conformity with the GATT and will submit legislation to do so shortly.

4. Caribbean Basin. As part of the withholding repeal package, the Senate also approved the President's proposal for trade and tax incentives to boost economic activity in the Caribbean nations. The Ways and Means Committee is marking up this week.

VI. Social Security

A. The National Commission developed a bipartisan package that deserves support. It is not perfect, and everyone had to swallow hard on some items: that is the cost of reaching agreement.

B. The work of the Commission made clear that we had to confront the crisis in social security. The Commission agreed that $150-$200 billion is needed between 1983 and 1989 to ensure the solvency of the system through 1990. This means providing about a 15 percent reserve ratio by 1990 under the pessimistic--some would say realistic--assumptions.

C. The bipartisan package, includes a 6-month delay in cost-of-living adjustments, partial acceleration of scheduled payroll tax increases, coverage of new Federal workers and non-profit organizations, and partial taxation of benefits for higher-income beneficiaries.

D. We cannot forget that the payroll tax burden is already heavy and scheduled to increase, and the confidence of young people is critically low. The long-term deficit can be reduced considerably by very gradually slowing the growth of the system as people come on to the rolls in the future. The bill raises the retirement age to 67, again very gradually, for people retiring some 20 or 30 years from now. Ample time is available for people to adjust their savings and retirement decisions.

VII. Trade

A. Trade deficit is too large. The size of our trade deficit (which is now projected at $60 billion or more in merchandise trade and $30 billion in current account) alone means Congress will continue to look hard for ways to reform our trade policy. The system of multilateral arrangements has been called into serious question as many believe it fails to meet our needs. Many voters and members of Congress will want to see us approach more of our trade problems on a bilateral basis. The average American simply does not understand why Japanese cars and TV's sell well here but American cigarettes, beef, baseball bats, and cosmetics cannot be sold in Japan. Remedies for this type of situation are certain to be a major focus of attention in this Congress.

B. Export issues. Unfortunately, the GATT ministerial failed to make progress on the question of foreign subsidies for agricultural exports. This will continue if pressure from Congress to resolve this situation through negotiation or for other export promotion actions like the recent wheat flour sale to Egypt. S. 822, recently passed by the Agricultural Committee, would establish several export promotion activities.

I support efforts to equalize the rules under which trade is conducted. This does not mean trade war, but does mean seeking to expand East-West trade, developing a viable substitute for DISC, utilizing Ex-Im Bank resources more adeptly, and enacting the trade reciprocity bill that the Senate approved April 21. Fair access to markets must be a two-way street, and Congress will be under considerable pressure to see that that is so.

C. Import issues. As you know, the House passed "local content" legislation at the end of the last Congress. That is a drastic proposal and likely to be counterproductive in the long run if our goal is to increase access to markets and to gain maximum benefit from the mutual advantages of international trade. There may be other areas, however, where we might make adjustments: in considering extension of the Generalized System of Preferences, there may be an interest on the part of some members of the Finance Committee to seek some reciprocal benefits from the major GSP beneficiaries. There appears to be substantial support for the trade provisions of the President's Carribean Basin Initiative, however, as those countries offer U.S. exporters a potentially strong market. It may be difficult to renew the President's general authority to negotiate tariff reductions on a limited basis.

D. Clearly the heat is on when it comes to seeing that American producers get fair treatment under our system of international trade. If we choose our battles carefully to secure an appropriate response from our trading partners, we have an opportunity to making trade freer and fairer, to the advantage of everyone. But we must avoid the two extremes of allowing the world to think only the U.S. will play by the rules of free trade, regardless of disadvantage to our citizens; or, on the other hand, taking extreme unilateral actions that may look good politically but that, in the long run, will provoke severe reaction and deprive us of market opportunities. We need just the right amount of leverage to open more doors, not have them slammed in our face.

VI. Conclusion

The months and years ahead must not be dominated by rigid ideologies on either side--but neither can the President or the Republican leadership be expected to cast aside the principles of Government the American people so soundly endorsed in 1980. Those principles--a more restrained Government, a freer economy, greater accountability to the American people--are as valid today as they ever were, and there is no indication that the people have changed their commitment to these same principles. Guided by these principles, we will try to work together to build on the sound foundation for recovery that has already been laid.

Additional Talking Points--Philip Morris Corporate Affairs dinner

Cigarette/Alcohol taxes

● The cigarette tax was doubled in 1982 for a three-year period, so it is unlikely Congress would turn to this revenue source again in 1983 even if there is a major revenue-raising bill. The Federal taxes on alcoholic beverages have not been raised in over thirty years, so there is a possiblity that some members would be interested in looking at those taxes as part of a revenue-raising package.

● Even in the case of the alcohol taxes, it makes sense for Congress to resort to an increase in this type of tax only if it cannot reach agreement on superior measures to raise revenue. The emphasis still should be on closing loopholes cutting back tax preferences, and taking additional steps to improve compliance with the existing tax laws. That is a simple matter of fairness, to look into those areas before raising any tax that directly affects the average American who is already paying his or her fair share of tax.

● Members are also sensitive to the fact that, while Federal alcohol taxes have not been raised, State and local taxes in this area have risen substantially over the past several decades. A hike in alcohol taxes is likely only as a gap-filler in a revenue raising package, when members fail to agree enough other tax changes to reach a mandated total--similar to the way the cigarette tax was raised in 1982.

● <u>Change sunset on tobacco tax hike</u>. Chairman Rostenkowski has proposed a so-called 'tax freeze' that would prevent changes in the tax law scheduled to take effect after 1983 from occuring. One of these changes would be the sunset of the tobacco tax increase scheduled for 1985. Ways and Means is holding hearings on this and other revenue raising options this week, but it is fair to say that the 'freeze' proposal did not exactly generate a groundswell of support, and there is no reason at this time to expect that Congress would be particularly receptive to this sort of change.

Alcohol tax/Medicare

● The suggestion has been made that an alcohol tax increase, with the revenues earmarked for the HI trust fund, would be an appropriate part of a Medicare bailout package. A similar suggestion was made off and on in the social security debate, but never went anywhere. Unless a clearer, well-documented link is made between alcohol use and medical expenses financed under Medicare, it is hard to see why this particular linkage makes sense. In addition, Congress is well-advised to avoid further 'earmarking' of particular taxes, which tends to insulate the associate part of the budget. This is particular true when there already is the HI tax, which is exclusively devoted to Medicare financing.

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