

page

Speak
JAMES M. CANNON

March 7
Thursday
8:00 shift
8:30 Speak
Mayflower Hotel
State Room
where?

February 11, 1986

The Honorable Bob Dole
United States Senate
Washington, D.C. 20510

Dear Mr. Leader:

You made such a hit with Merrill Lynch partners when you spoke to them here on December 5 that they want you to come back for an encore.

Bill Shreyer, Chairman and CEO of Merrill Lynch, and Dan Tully, President, have asked me to invite you to speak to the Merrill Lynch Million Dollar Club, which is made up of the top sales executives for investments.

This select group of Merrill Lynch leaders is coming to Washington for a series of briefings on Thursday and Friday, March 6 and 7, 1986. They would very much like to hear from you at a convenient time on either day on any subject you might like to discuss.

Merrill Lynch would, of course, pay you the maximum honorarium and provide a car for you.

In addition, I think you would find these Merrill Lynch executives interesting. All are seasoned professionals of great experience; all are skilled at working with their clients on domestic and international investments. Most are Republicans.

I would be personally grateful if you would consider this.

Sincerely,

Jim or Louisa

227 Massachusetts Avenue, N.E.
Washington, D.C. 20007
547-6200

\$2,000 hon.

February 21, 1986

The Dollar, Exchange Rates, and Trade

- o Last September the Reagan Administration reached agreement with the "Group of Five" (the U.S., Japan, West Germany, France, and Britain) on a plan of coordinated action to moderate the value of the dollar. The major shift in U.S. policy that emerged from that agreement was a willingness to resort to coordinated governmental intervention in exchange markets in an effort to ease the dollar down.
- o No doubt about it, the new policy has had an effect. Since last September the dollar has declined over 20% against the yen, and over the past year between 20% and 30% against other major currencies. That should improve our trade position by later this year, but there may be further slippage in our trade position before then--partly because some of our foreign competitors may try to cut prices to preserve market share, at least temporarily, to offset the dollar's decline.
- o While there appears to be a dispute between Chairman Volcker and Secretary Baker over what to do next--Baker seems to prefer a further decline in the dollar--there may be less here than meets the eye. Our ability to regular the value of the dollar is limited by economic fundamentals in any event. The real risk comes if we try to drive down the dollar without meeting the other commitments we made in September.
- o Specifically, we agreed to reduce our budget deficit dramatically and keep our markets open. Attacking the deficit, then, has got to be our top priority if we want to improve our trade position.

TAX REFORM EFFECTIVE DATES

- o Last December the Senate passed my resolution urging that the effective date for most provisions of tax reform legislation should be January 1, 1987. The reason for making tax reform "prospective only" is to eliminate the cloud of uncertainty that pending tax reform legislation leaves over many economic decisions that are influenced by tax policy.
- o The House also passed an "effective date" resolution, urging the chairman of the tax-writing committees to agree on some determination of effective dates other than the January 1, 1986 date in the House-passed bill.
- o Unfortunately, since last December little progress has been made in clarifying the effective date issue. Chairman Rostenkowski has made it fairly clear that he thinks the House bill effective dates are appropriate, although he is willing to remain open to selective changes in those dates.
- o Last week eleven members of the Finance Committee sent a letter to Senator Packwood urging that markup of tax reform legislation be delayed until the effective date issue is resolved. I am not sure that is the best strategy, but it is another indication of how much members are concerned about the effective date problem.
- o There is still some hope that Rostenkowski, Packwood, et al. can agree on a statement to resolve some of the uncertainty on effective dates. The closer we get to Senate action on the tax bill, the more likely it becomes that Senate's decision on effective dates will be the most important signal we give to the business community of our intentions on the issue.

February 25, 1986

Tax Reform Talking Points

- The President's tax plan and the House bill are similar in concept--they both shift more of the tax burden to corporations and reduce the tax burden on individuals. But the bills are very different in how they make the change.
- Both substantially reduce tax rates for individuals (the President to a maximum of 35%; Ways and Means to 38%) and for corporations (President 33%; Ways and Means 36%). But the Ways and Means rates take effect at much lower income levels: the 35% rate clicks in at \$43,000 for married couples, as opposed to \$70,000 under the Reagan plan.
- Neither plan gets an A+ for the major objectives of tax reform--simplification and fairness, but the President's plan repealed many more of the overly complicated provisions of the tax code than the Ways and Means Committee effort. The House bill just modifies, but leaves in place, many complex tax rules.
- The House bill falls far short of the President's on fairness grounds. Fringe benefits and itemized deductions are major causes of differing tax liabilities, and unlike the President's proposal, the House retained the State and local tax deduction, did less to limit interest-paid deductions, and did nothing on fringe benefits. This means that taxpayers with equal incomes can still have substantially different tax liabilities.
- I have personally long favored income tax reform and, as Chairman of the Senate Finance Committee, led the fight over a number of years to plug unjustified tax loopholes.
- The Senate Finance Committee now is expected to begin action on tax reform in the second or third week of March. A lot of difficult decisions await the Committee if it is to make significant progress towards the goals the President has outlined: lower tax rates, a \$2,000 personal exemption for everyone, and more incentive for saving and capital investment.
- I strongly believe that whatever we do on tax reform should be confined to trade-off between broadening the income tax base and lowering income tax rates for business and individuals. We should not resort to the gimmick of new taxes or add on taxes just to avoid tough decision on tax reform.

-2-

- o Above all, we should not lose sight of the basic goals of tax reform: lower rates and a more equitable, level playing field that will be more productive for the economy and fairer to the average taxpayer. This is the latest step in the direction we set when we indexed the tax code in 1981 and began major tax reforms in 1982.

THE ECONOMY IN 1986

- o No one can really predict the course of the economy in 1986, although of course we have to take a stab at it to guide our budget decisions. But it is increasingly clear that the economy began picking up late last year. Leading indicators rose 0.9% in December, the eighth month in a row. Unemployment is down to 6.7%, the lowest since 1979.
- o There are forces at work that improve the prospects for strong growth this year. One of these is the drop in oil prices, which acts like a tax cut for energy users and helps moderate inflationary pressures that might build as a result of the dollar's decline. Coupled with the monetary stimulus the Federal Reserve provided in the last six months of 1986, and the prospect for improvement in our balance of trade later in the year (as the effects of the dollar decline are felt), this means we have a good chance for healthy growth in 1986.
- o Clearly the number one threat to maintaining a healthy economy remains the U.S. budget deficit. If it's not reduced sharply this year, we won't meet the commitment we made to our trading partners to secure their agreement to ease the dollar down. What's more, we would put an unconscionable burden on the Federal Reserve to keep the recovery going by pumping more money out in order to keep interest rates down. That's a sure recipe for inflation.
- o We've created 9 million jobs with a near record economic recovery. We've got inflation down to the lowest levels in two decades. Let's not throw it all a way by punting on the deficit issue. The fact is that all the economic pundits we've been hearing in recent years have been wrong: the economy is more resilient than many believed, but not so strong as to be able to sustain huge deficits this late in the recovery. It's time for everyone to "give" a little in the interest of a deficit-reduction plan that will steer us safely through the potentially treacherous waters ahead.

Gramm-Rudman, the Dollar, and Inflation

- o Gramm-Rudman should help us meet the commitment we made last September to our trading partners: to reduce the deficit as part of our effort to moderate the value of other dollar.
- o By the same token, the risk of inflation should be reduced if we bring down the deficit under Gramm-Rudman, because the pressure to pump up the money supply to keep interest rates down will ease considerably.

Gramm-Rudman: Challenge to the Established Fiscal Order

- o The first actions in response to the new Gramm-Rudman deficit control reform will be taken early in 1986. For those of you who missed it, late last year the Congress imposed a new fiscal straightjacket on itself. The new law sets firm deficit targets for each of the new five years, and mandates automatic across the board spending cuts if the deficit exceeds the target. The first round of automatic cuts under the proposal will take effect March 1 unless Congress comes up with a better way to meet the target.
- o In addition, President Reagan's budget for fiscal year 1987 is due to Congress by February 5. So we will have reconsideration of the 1986 budget proceeding simultaneously with our first shot at the 1987 budget.

That is a tall order, but is one we ought to be able to fill. Difficult as it seems, we should remember that the Gramm-Rudman law contains new procedures designed to make it easier to meet the deficit targets. We explicitly bring loan programs and other 'off-budget' items into the budget process; set a point of order against legislation from committees that have not met their budget savings allocation; and rule out of order legislation inconsistent with the deficit targets.

Possible Problems. We know there will be a rocky road ahead in implementing Gramm-Rudman. Congressmen Synar and others already have won the first round in their suit claiming it is unconstitutional, and the Reagan Administration also has some problems with the role of the Congress' General Accounting Office in mediating the deficit forecasts. The Supreme Court will have to give us a final ruling on all that in a few months. Even more important, what Congress can legislate, Congress can back out of. That's why we need a constitutional mandate for budgetary restraint, as well as a statutory one.

- o So Gramm-Rudman hasn't made our options any easier: but if it works as planned, it will force us--and the President--to make some decisions and choose among the various deficit-reduction options. That means everyone's cherished spending programs will be put to the test of fiscal responsibility.

Spending the Key. Finally, let me emphasize that Gramm-Rudman is a device for reducing Federal spending. It is not a tax increase plan, or a subterfuge for one. If we fail on the spending front, we can look at other options. But the sooner we entertain any revenue options, you can bet the pressure for spending cuts will drop fast.

The Deficit and the Average American

- o Unless we follow a deficit reduction path like that mandated under Gramm-Rudman, American families will face either higher interest rates or higher inflation: not to mention the risk of a disastrous new recession throwing millions of breadwinners out of work. That is what the Gramm-Rudman-Hollings initiative is all about.
- o Most economists believe that enactment of deficit reduction measures that eliminate the deficit by the end of the decade will produce a drop of at least 1 percent in interest rates over the short run and 2 to 3 percentage points over the long term: relative to what they otherwise would be.
 - With a 2% drop in interest rates, the monthly payment on a median priced home (\$80,000) would go down by about \$100 a month.
 - Conversely, if we don't reduce the deficit to keep rates as low as they are now, homeowners could face that large an increase--or more-- in monthly payments.
 - A 2% drop in interest rates would mean an additional \$4,000 in income for the average wheat farmer with a 1,000 acre operation.
 - In 1985, the Federal Government will overspend close to \$1,000 for every man, woman, and child in America.
 - This \$1,000 per head of additional federal debt will be one more burden for our children to repay in higher taxes or higher inflation in the future.

Interest on the Debt

The massive increase in debt has itself created one of the largest and fastest growing components of Federal spending--interest on the debt. Constant deficits have put fiscal policy on an endless treadmill of paying for the irresponsibility of previous decades:

- o In 1965, interest on the national debt cost \$9 billion and consumed 1.4% of GNP. By 1980, annual interest costs rose to \$52 billion--2% of GNP. But the worst was yet to come.
- o In 1985, interest on the national debt cost taxpayers \$130 billion--almost three times the level of five years ago. this represents 3.8% of GNP, 13.5% of the entire 1985 budget, and a 1,450% increase in costs over 1965.
- o \$130 billion is equal to the sum total of all Federal spending from 1789--the founding of the republic--to 1936. It also equals total Federal outlays in 1966, the entire defense budget in 1980, and twice the level of medicare funding today.

But if we can adhere to the deficit-reduction goals we've set for ourselves, I am very, very optimistic about the course of the economy. I think we take too much for granted what we have achieved so far: strong growth without inflation. We can keep that going if we reduce the deficit substantially. The way is open to economic performance unprecedented in the postwar period if we have the will to find it.