The Economic Club of New York

309th Dinner
78th Year

The Honorable James A. Baker, III
U.S. Secretary of the Treasury

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Questioners: Virginia Dwyer
Senior Vice President - Finance
AT&T Corporation

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Introduction

Chairman Dwayne O. Andreas

Mr. Secretary, ladies and gentlemen, welcome to this 309th dinner in the 78th year of the Economic Club of New York. Our members who have interest in London will be especially pleased to know that we have a distinguished member of the British Parliament, Mr. Alex Fletcher, among our guests tonight. (Applause) As Parliamentary Under-Secretary of State in the Department of Trade and Finance, he will be the one steering through Parliament legislation arising from the white paper on financial services in the United Kingdom. Mr. Fletcher, would you please rise so our membership can see you. Thank you. (Applause)

I also want to express our special appreciation to Pete Peterson for arranging tonight's guest speaker to join us. Pete, thank you very much.

I feel very comfortable tonight introducing our guest. Quite apart from being a friend, he is a man whose activities I have had the good fortune to observe over a period of many years. Our guest is a man who was trusted and selected by three of the great leaders of our country for heavy responsibilities. And I know for a fact that all three of them are glad that they depended on Jim Baker.

He has been Under-Secretary of Commerce. He was Campaign Director and Chief Advisor to

President Ford in 1976, for George Bush in 1980, and White House Chief of Staff for President Reagan. As the new Secretary of the Treasury, he will soon find out whether the first two months are the hardest or the easiest. One of his favorite pastimes is hunting wild turkeys on his Texas ranch. I am sure that as Secretary of the Treasury, he won't be going there so often. The proposals that come his way will surely include enough wild turkeys to keep him occupied full-time shooting them down. Jim, keep your marksmanship in practice.

Jim Baker is a lawyer by training, a political leader by experience. When I think about what Jim can bring to Treasury, I think of a point once made very forcefully here by a British Chancellor of the Exchequer in an address to this club. The year was 1932 and the Chancellor was Winston Churchill. Churchill distinguished between the separate roles of political leaders and experts. "There is," he said, "a broad division of labor. On the great questions, experts will disagree, he said. It is the duty of statesmen to set out the objectives and of the experts to figure out how these objectives can be best attained." "The government," Winston Churchill said, "is the master and the expert is the servant."

As Secretary of the Treasury, Jim Baker is a statesmen whose role in Churchill's scheme of things is to help decide the great questions, to set the great goals, to make the political determination of which goals are desirable and attainable. Jim Baker has proved that he has that uncanny facility of instantly and instinctively understanding what the people of this great country will or will not accept and that is the hallmark of a great leader. Jim Baker has won the reputation as a legislative strategist, of exceptional skill, and as a master of the art of the possible. He can reconcile the seemingly irreconcilable. He has proved himself a man of both serious purpose and of high purpose. He has loyally served his president and he has loyally served his country at great personal sacrifice. He has shown that he understands the difference between posturing and performance. And I can assure you he knows what makes America tick.

As he takes charge of the Treasury Department, he does so with our thanks, with our hopes, with our confidence, and I might add, with our prayers. He has a tough job, and he has shown that he can do a tough job. And he has that sense of balance that time and again has proved the nation's salvation in a time of political turmoil.

And now, ladies and gentlemen, it is my great pleasure and my great privilege to present to you the 67th Secretary of the Treasury, the Honorable James A. Baker III. Thank you. (Applause)

The Honorable James A. Baker, III

U.S. Secretary of the Treasury

Thank you very much, Dwayne, for that overly generous introduction. Ladies and gentlemen, I'm delighted to be here this evening. This is, in fact, my second attempt to speak to the Economic Club of New York. I was invited back in 1982 but budget matters forced me to cancel at the last minute so I thank you very much for this rain check.

It's a pleasure to be here this evening, and it's an honor for me to address such a distinguished group. Dwayne touched on – I know we're here tonight about matters economic – but Dwayne touched on politics in his introduction and that reminded me of a brief story that I really ought to share with you as we get started about my one foray into elective politics. Back in 1978, I, for some reason, got a wild hair to run for statewide office in Texas which I did. And I remember going all over that great big state with a standard stump speech that I used to make about the importance of being involved and the importance of being interested in the public policy process, and I know that's why many of you are here tonight, is because you are interested in the public policy process. And I had this speech that I would make, and I never will forget one hot summer afternoon in a bar in Amarillo. It was a bar because I would speak to any group that I could find that would listen to me. And I remember standing up there and making the points that I was making all over that big state that year, that there were two fundamental problems facing the state of Texas – ignorance and apathy. And I turned to the fellow sitting at the bar there and I said, what do you think about that, sir? And this grizzled, little guy looked over his beer, he looked up at me and said, well, I'll tell you sonny, he said, I don't know and I don't care. (Laughter) I know that's not why you're here tonight.

In case you haven't noticed, ladies and gentlemen, today is April Fool's Day when everything is a joke. This contrasts with April 15th when nobody's laughing. (Laughter) And I know that a lot of you out there are concerned about the economy, but I've got to start this talk by telling you at the

Treasury Department we see no problems. That's because we make money the old-fashioned way. We print it. (Laughter and Applause)

But seriously, a lot has happened in the time between that first invitation to speak and today. Back in 1982 the country was in recession, but I think with honest optimism I still would have told you that the future looked bright. Today is that future. We're in the 29th month of recovery and growth. Our economy has been shining with real growth last year, the highest since 1951. Hundreds of thousands of jobs are being created every month – over seven and a half million jobs during this expansion. Capital spending has outpaced gains during any previous post-war recovery. And inflation has been held down dramatically below the double digit levels that were crushing our spirit and ruining our economy only a few years ago.

I'll admit to a little bit of bias, but I think the reason for all this success and the reason that even in 1982 I could have spoken here with optimism has been the unyielding belief of this administration in sound common sense economic policy and the unwillingness to buckle under to pressure for traditional quick fix solutions. We held on doggedly to our faith in the power of free markets, incentive-spurring tax cuts, and the creativity of the individual. We pushed hard to control Federal spending, cut needless or out of date regulation, and restore economic power to the people.

The result: America's economy has been catapulted out of the stagflation and morass of the 1970s, and more importantly we have restored confidence in market-oriented economic policies.

We have renewed our faith in America's power to produce jobs and well-being through growth, and in so doing we've begun to lay a firm foundation for sustained economic development without inflation.

We have returned to a position of strength in the world economy as well, and this American economic might is helping to pull other nations up off the mat. Most haven't recovered to the extent we have and this, along with the international debt problem, has kept the relative attractiveness of the United States investment strong, and thus has kept the dollar strong –stronger than many would like. But even those who find fault with the dollar's strength are realizing, I think, that the United States cannot go back to the traditional quick fix mentality.

Rather than artificially lowering the dollar, others are coming to see that sound, convergent, market-oriented economic policies are the best means to assure long-term stability. With the international debt problem we've seen a similar acceptance of work, dedication, and patience as the proper means to overcome a serious threat to the worldwide financial system.

At the 1983 Williamsburg Summit we adopted a five-point strategy for managing the debt problem. Its basic elements were, and are, economic adjustment by debtor countries, growth and more open markets in the industrialized nations, adequate resources for the IMF, continued bank lending to those countries who are making determined adjustment efforts, and emergency bridge loans by governments to aid adjustment programs. That strategy is working. The process is not always easy. In fact, it is often difficult for all concerned, but it is effective.

We're encouraged by the progress of Mexico, the nation that led off a wave of debt problems in Latin America and elsewhere two and a half years ago. Mexico has battled back and is now held up as a model for other debtor nations to follow. The battle is from over, but in Mexico and throughout the international community if we stick by our basic strategy and if the debtor countries, the IMF, the lenders in industrial nations continue to work together, then the debt problem will continue to be manageable in the short term and perhaps even solvable in the long run.

In the meantime, we've got more to do right here at home. It would be a serious mistake, I think, to let this recovery breed complacency. Our domestic economy is growing and thriving as a direct result of economic policies implemented in 1981. We must build on what we've started, and we must extend those policies and philosophies that have brought us this far, for they promise to carry us much further.

I'd like to interject here that I am not troubled by the first quarter "flash" for growth in inflation. The early data suggests that GNP is rising at only a little over 2% while the gross national product deflator is projected at above 5%. However, many private economists believe that this "flash" estimate reflects a number of abhorrent technical influences and that real growth has been understated while inflation has been overstated. In addition, February's leading indicators suggest that we'll continue to see moderate growth. And I believe we will see growth continue for a long while yet, if we continue what we started four years ago, and if the Congress acts responsibly to implement the president's program.

Our efforts right now center on the control of Federal spending and on tax reform. These are top two domestic issues. On spending control, we are encouraged by the way the terms of the debate have been framed. No longer is the question, should we cut spending? It is now, how should we cut spending? On tax reform, we are undertaking an historic challenge, and because at the president's direction I am leading the administration's efforts to refine our proposal, I want to devote the balance of my remarks tonight to this topic.

I remember my first briefing on the subject as Treasury Secretary. One of my advisors told me, Mr. Secretary, I know you think coming up with passable tax reform legislation is going to be very tough, but I don't know why you feel that way. After all, there are only two types of people complaining about the tax system – men and women. (Laughter) And that about sums it up, I think.

A lot of people are complaining. In fact, recent studies find that four out of five taxpayers believe the present tax system benefits the rich and is unfair to the ordinary working man or woman. A majority of taxpayers believe the Federal income tax system is too complicated and a majority think that cheating on income tax is rampant. I think it's clear that where our tax system is concerned, there is widespread populous sentiment in favor of major reform. And more importantly, this sentiment is rooted, I think, in legitimate concerns.

Now, of course, there is substantial resistance to some of the particular changes that would be brought by a comprehensive tax overhaul. I suppose that's no secret to this group here tonight. But we firmly believe that the majority of Americans would forego some aspects of the system which benefit them individually for a simpler and fairer system with lower tax rates overall.

More than 70 years of piecemeal changes in the tax code has culminated in a system that has fundamental shortcomings. It is riddled with inequities. It has grown unacceptably complex. It requires high tax rates to provide sufficient revenue, and it is adversely affecting what should be economic decisions by businesses, investors, and yes, even average individual taxpayers. And perhaps most importantly, the present situation has led to a loss of respect for the tax system generally which translates into a loss of respect for government. To the extent that we can improve our tax system, we will be improving government, and we will be improving the public's perception of government. To the extent that we fail to do so, we will be allowing a regrettable and corrosive tendency toward alienation and cynicism to persist.

I know that problems with the tax code aren't news to you. For years we've heard the complaints and Washington has often taken a stab at tax reform. But it's only recently, since the president directed a full study in his State of the Union Address a little over a year ago, that real, comprehensive reform has become a possibility. He reconfirmed that concern in the most recent State of the Union two months ago. He spoke of a second American Revolution, a revolution of hope and opportunity for all Americans. Tax reform is a part of that revolution. It's not an easy task, and we certainly do not underestimate the difficulty involved, nor do we minimize the importance of the action. In fact, tax reform is among the most ambitious undertakings of this administration. But the time for such bold action hasn't been better in many years. We've got a thriving, strong economy as I've said, and believe me, that makes our efforts a lot less difficult.

We've also got something of a consensus among the leading proponents of tax reform. All of them agree that our present system is flawed and that some kind of comprehensive reform is needed. And among the major reform proposals, the same basic philosophies are shared, even if all the same specifics are not. We've been meeting almost daily with members of Congress, representatives of the business community, and other affected parties. And we're entering these discussions with open minds, a willingness to listen, and a willingness to examine all aspects of reform. There's not much for our part that's etched in stone, but there are several important general guidelines that we think should shape the dialogue.

First of all, we believe that tax rates are still too high and should be reduced. High tax rates stifle incentives to work, to save, and to invest. They discourage invention, innovation, and risk-taking. They encourage wasteful tax shelter investment, and they stimulate underground economic activities. It is far better, I think, to levy a lower rate of tax on all income than to tax only some income at extremely high rates. By bringing untaxed income into the tax base, we can reduce high marginal tax rates for both individuals and corporations without any loss of revenues in the short run. In the longer run, those lower rates should lead to even higher revenues through sustained growth of the tax base.

Secondly, any tax reform proposal must be revenue-neutral. The administration is adamantly opposed to reform being a tax increase in disguise. Now this means grappling with two forces that we know are lurking in the shadows – those who will attempt to combine tax reform with deficit reduction and those who will lobby hard to have their special tax treatment retained in any new tax law. We can't give in to either pressure. Tax reform and deficit reduction each has its own singular importance. Both are economic priorities, but they must remain as separate issues. Similarly, the special interests must understand that we cannot exempt every preferential treatment, deduction, and credit that has a constituency and at the same time bring tax rates down.

Now having just said that, I'm going to mention one item that we do want exempted, and that is the deduction for home mortgage interest. It is part of the president's concern as well as ours that families be treated fairly and assigned the importance they deserve as the foundation of American society. Widespread home ownership provides a sense of well-being and social stability that we believe strengthens the family and through that strengthens society. The deduction for mortgage interest makes home ownership easier and more likely and warrants special consideration.

Even more important, under our fairness to family guideline is that people living in or near the poverty line should pay no income tax. I don't think too many would argue that those applying everything toward the bare necessities of life should not have the added burden of income tax.

A fourth criterion is formally called economic neutrality. Simply put, this means all sources and uses of income should be taxed equally. And this requires again that most special exclusions, adjustments, credits, and deferrals that favor certain sources and uses of income be eliminated. We believe that a free market is the best method for allocating resources in the most efficient manner. It provides the best data and best signals for investors, consumers, savers, and businesses. But right now our economy, in some respects, can be severely distorted because what should be economic decisions are decisions driven instead by tax considerations. While a pure economically neutral system may be unattainable, we should make every effort to devise a system as unbiased and economically efficient as possible.

I know this aspect of tax reform is of great importance to many in this audience. There's been a concern on the part of many in the business and industrial sectors that some reform proposals may damage capital formation. Let me assure you that we will be looking carefully at these elements of any plan. We do not want to kill the goose that lays the golden egg.

Our overall economic objective is and has been stronger economic growth. There is no contradiction between tax simplification and economic growth. They can and should go hand in hand. We're well aware of the integral part capital formation plays in providing and sustaining growth in an economy. And we're well aware that economic risk and investment are functions of potential gain. We obviously need to find a balance. We need the entrepreneurs, the innovators, and the risk takers.

And finally, the complexity of our tax code seems to be the Federal government's unintended method of adding insult to injury. And because of ever-changing statutory provisions, I don't see the system growing any simpler on its own. So simplifying the tax code must be among our objectives. Within this framework lies a good foundation for tax reform. We will not abandon the guidelines I've gone through today, but we are receptive to sound suggestions and alternatives that may benefit taxpayers and the economy.

One alternative that we don't feel we have is inaction. What our tax system has developed into is contrary to much of what has powered this nation for two centuries. To let the present system of piecemeal change and debilitating complexity continue would be to risk a lot. Eventually a flawed tax system would catch up with us and the price would be less growth, less opportunity, and less hope.

Perhaps you've heard it said that destiny is not a matter of chance, it is a matter of choice. It is not a thing to be waited for, it is a thing to be achieved. Well, the way I see it, we can take a chance and wait, or we can make a choice and achieve. It's clearly up to us. I think our decision should be evident. Thank you very, very much. (Applause)

QUESTION AND ANSWER PERIOD

CHAIRMAN DWAYNE O. ANDREAS: Thank you very much Mr. Secretary. I am sure you will find a great deal of important support in this room for the objectives that you outlined in your splendid presentation. Now as is the custom of the Economic Club, as is our tradition, we will have two questioners tonight. We have here two distinguished members of this club, Mrs. Virginia Dwyer, Senior Vice President for Finance of AT&T, and James Burke, Chairman and CEO of Johnson & Johnson. With your permission, Mr. Secretary, I will first call on Mrs. Virginia Dwyer to ask the first question, and you can alternate as you see fit from there.

VIRGINIA DWYER: Mr. Secretary, the Treasury's tax reform proposal really constitutes a very complex and immediate rearrangement of the tax system that is bound to have powerful, but I think uncharted, effects on society and on the economy. Studies by highly qualified economists and tax specialists have reached differing conclusions about the impacts of the proposal on economic growth, employment, trade balance, and unemployment. In view of that, should the tax law be changed so radically in one set of actions when there are major disagreements as to its effect on the economy?

THE HONORABLE JAMES A. BAKER, III: Well, I suppose I would answer that by saying that if you don't change it in one year, if you don't have comprehensive reform in one year, the political likelihood is that you will not have comprehensive tax reform beyond the type that we've seen take place piecemeal over the years and that's what led to the kind of tax code we now have. So if we don't, if it doesn't happen in a year, and the best year for that would be this year, you may not see comprehensive tax reform at all. So I think we should have it and we should have it this year. (Applause)

JAMES BURKE: Mr. Secretary, getting to some of the nitty-gritty of tax reform, and I think it's hard to argue with the legitimacy of tax reform, I think our concerns are some of the issues that Virginia spoke of. One of the keystones of President Reagan's economic recovery and growth programs in 1980 was a reduction of existing disincentives for business investment through the adoption of an accelerated cost recovery system called ACRS and retention of the investment tax credit called ITC. The Treasury now proposes to eliminate the investment credit and to replace ACRS with a decelerated recovery system which in effect penalizes investment in capital equipment. Do you feel this reflects a change in the administration's basic philosophy?

THE HONORABLE JAMES A. BAKER, III: Well, the intention is not to change the administration's basic philosophy. But perhaps I should say here, for the benefit of some out there who may not know, that my instructions from the president are to look at each and every element of the tax reform proposal that Treasury came up with right after, well, sometime, it was announced sometime in December I think, to see which of those we should stay with and which we should recommend changes in. Now I have to tell you that one reason that the Treasury-1 proposal calls for the elimination of ITCs and the scaling back of ACRS is because we have a situation in this country where, as a result of those provisions, as a result of the ACRS provision that was enacted in 1981 coupled with ITC, we have a situation where there are some companies which in effect have negative income tax rates. That's one of the things that leads people to think, the average taxpayer out there, to think that somehow our tax system isn't fair when we have major corporations that earn money that don't pay taxes. So the thinking is that there ought to be a close look at those provisions. I've also said, I said it during my remarks earlier and I have testified on a number of occasions before the Congress, that I think it's important that we look at each element of the proposal with a view to what it does or does not do with respect to capital formation. Because again, as I said a minute ago, we have no desire to kill the goose that lays the golden egg. At the same time, we do have a desire to correct what we perceive to be abuses and inequities in the present system.

JAMES BURKE: Thank you Mr. Secretary. I'd like the audience to know that Johnson & Johnson is not one of those companies that doesn't pay taxes. (Laughter)

THE HONORABLE JAMES A. BAKER, III: Then you're not interested in ACRS and ITCs, are you? (Laughter)

JAMES BURKE: I didn't say that.

VIRGINIA DWYER: Mr. Secretary, following on the previous question that had to do with capital formation, there's another area that is very important in the present considerations and that has to do with the R&D tax credit. And I believe the original proposal continues the R&D credit for a period of three years. And one of the concerns here is that with the long run nature of research and development and its importance to the technological progress here, whether you would care to comment on the possibilities of that being continued as a permanent credit or a longer term than three years?

THE HONORABLE JAMES A. BAKER, III: Well, let me just say that the proposal in Treasury-1 to retain the R&D tax credit is a proposal that has met with widespread acceptance – one of the few proposals in the package that is universally acclaimed. I'm really not in a position here tonight to say what our recommendation to the president is or is not going to be with respect to any particular element of the tax plan because my job is to make my recommendations to him. I will say to you that we have, that's one provision that we have had practically no complaint about, in contrast to practically every other proposal in the package.

JAMES BURKE: Mr. Secretary, the Treasury proposal abolishes Section 401K plans and replaces them with higher deductible limits on contributions to IRAs. Recent surveys show that of all individuals eligible to establish IRAs, only 17% have done so. And in sharp contrast, nearly 75% of those eligible to participate in Section 401K plans do in fact participate. One of the most successful programs we at Johnson & Johnson have to encourage employees to provide for their retirement is a savings plan qualified under Section 401K. Why abandon such a good product?

THE HONORABLE JAMES A. BAKER, III: Well, there's been a great proliferation, as you point out, Jim, of 401K plans. You could ask that same question about the proposal to eliminate any other, any number of other deductions, preferences, credits, all of which it could be argued serve a useful public policy function. But the bottom line is if you want to reduce tax rates overall and if you want to simplify and make the system more fair to the average taxpayer, you cannot keep all of those preferences, deductions, and credits. And I might say this, that while we like to take, we like to take credit for what ACRS and some other provisions that were enacted in 1981 did, I think we shouldn't lose sight of the fact that the overall rate reduction that was obtained in 1981 has played a large part in the economic expansion that we're enjoying today. The bottom line is you simply cannot have all of these special deductions, preferences, and exclusions if you're going to reduce tax rates overall, not just for individuals but for corporations as well as the Treasury proposal does. (Applause)

VIRGINIA DWYER: Mr. Secretary, turning from the tax reform proposal for the moment and moving to the high value of the dollar in U.S. foreign trade as a matter of great concern to U.S. industry, could you comment on any conditions in current foreign trade and monetary situation which would cause the administration to support a more active role in intervention in foreign exchange matters?

THE HONORABLE JAMES A. BAKER, III: Well, the administration's policy with respect to intervention, as you probably know, is to intervene only when the markets are disorderly. And we have pretty well stuck to that policy in the eight weeks that I have been Secretary of the Treasury. (Laughter) How's that for a non-answer? It's really hard to talk about intervention. In the first place, if it's going to work you've got to keep the speculators guessing and the worst thing you can do is tell them when you're going to intervene and when you're not. So I probably ought to leave it right there. The policy hasn't changed. It's still a tool, it's there. I suppose it's no secret that many, particularly on our side of the table in international fora question the effectiveness of intervention in a situation where you have $125 - $150 billion in dollars trading every day.

JAMES BURKE: Let me broaden Virginia's question so we don't let you off the hook that easily. There's been a lot of talk about the ballooning domestic deficits and interest costs to service that debt which could reach $200 billion or more by 1989. There's been less talk about the foreign debt part of this. If the unprecedented current account and trade deficits continue, the Institute for International Economics estimates that with the dollar staying at the current levels, our debt to foreigners could, by 1989, reach $1 trillion which they find financially unthinkable and inconsistent with the president's objective of a strong foreign policy. If this is a problem, and it sounds like one to me, what specifically can or needs to be done, to get the dollar down, the trade and current account deficits down, and these huge foreign debts from accumulating?

THE HONORABLE JAMES A. BAKER, III: Well, one of the things we could do and are trying very hard to do is to reduce our fiscal deficit, and we haven't talked a lot about that tonight. I suppose we will later on. Another thing we can do is to see what we can do to improve the economies in those countries that represent our major trading partners. I happen to believe that we're making some progress in this regard. I have attended the last four economic summits with the president. We talk a lot at those summits about encouraging our major trading partners to adopt the same economic policies, growth-oriented economic policies that we've adopted in this country. And would you believe that a lot of them are now coming back and asking us specific questions about doing just that. And in the long run that's the real answer to the trade deficit problem. Of course, we've got to vigorously enforce our dumping and countervailing duty laws. We've got to vigorously enforce our trade laws. We've got to continue to negotiate as strongly as we can with the Japanese and see what we can do about getting them to open their markets to our goods and products. The one thing in my view that we can't afford to do is start a trade war and yield to the temptation to, if you will, be protectionist. I agree with you that that would be an unacceptable level. Your question, I think, assumed that the dollar would stay at its current level, and we're all aware that there's been a 10% decline in the dollar over the course of the past ten or twelve days. It's not that that's enough for some, but I don't think it's a hopeless situation by a long shot, Jim. And the one thing I think we cannot afford to do is to go the protectionist route because I think that's a street down which we simply cannot afford to start. We've got to remember, it's a two-way street. I suppose we all remember Smoot-Hawley and we all remember what happened back in the 30s. (Applause)

VIRGINIA DWYER: Following on that question just a bit, in some of the industries in the United States, the trade problems began to emerge before the dollar began to strengthen. And even if we solve the problem of the current value of the dollar, there's a question about whether the economic pressures to move some of the, particularly the high technology production offshore, are probably going to intensify. And I wondered if you care to comment on the administration view of that possibility and what possible steps could be taken to take care of it?

THE HONORABLE JAMES A. BAKER, III: Well, I'm not sure that I could assess the, could quantify the possibility. I think the steps that would be taken are the same that I outlined in answer to the prior question. We've got to be competitive. There are some industries in this country that are simply not competitive. And I don't want to name those industries, but I suppose we could guess at them. It's very difficult. It's very difficult with a declining industry to say what you would do because you end up always coming back to some form of protectionism. And the minute we start protecting, let's say against Japanese automobiles, you're going to see our farmers shut out of those markets to an even greater degree than they currently are and you just, that's just not the route to go. I'm not sure that it's not more the fault of the high dollar quite frankly than an inability on the part, particularly of our high tech industries to compete. It seems to me as the dollar comes down you're going to see; you're going to see strong competition by American industry in that area.

JAMES BURKE: Assuming, staying with the trade deficit problem and getting to a point you properly said we haven't talked much about, assuming that the budget deficit is clearly linked to the strong dollar and the trade deficit, how can we possibly get at the budget deficit in terms of spending – and I think most of us agree that spending is the root to get after that deficit – when the Congressional Budget Office and OBM would agree broadly that our receipts in 1985 and through 1989 are somewhat less than 20% of the GNP and defense, entitlements, and interest costs alone are more than 20% of GNP so we start out in a deficit just on those three factors alone, and the president has said that we won't touch defense and that we won't touch entitlements?

THE HONORABLE JAMES A. BAKER, III: Well, I would just, I would point you in the direction of the budget that the president sent up, Jim, which you know and I don't know whether everybody here knows, but they should know, that the president's fiscal 1986 budget represents an overall freeze in overall program spending, which means that it contemplates spending no more for programs in fiscal '86 than we'll spend in fiscal '85. So you can get there. And if you run that all the way out to 1989 and 1990 you have a deficit of only about 2% of GNP which I think we would find in that year to be, or that would be an acceptably declining path, deficit declining path. So the budget is there. The way to do it, the president has demonstrated the way to do it. All Congress has to do is enact the legislation that's required to put that budget into effect and you get there. Now you'll be met with a lot of screams and cries about this is politically unpalatable, we can't do it politically, it's too tough. It took a fair amount of political courage for the president to send that budget up there. And it's obviously always politically easier to raise taxes than it is to cut spending. But I think we ought not to lose sight of the fact that revenues as a percentage of GNP now are 19%. Between 1955 and 1980 revenues as a percent of GNP were 18.6% on the average. So it's not a case of our being under-taxed. Revenues are at their historically high level. It's a case of our overspending. Spending is up around 24, 24 ½% of GNP. How do you get there? You enact the president's budget.

VIRGINIA DWYER: Part of the budget trimming aspects of the president's budget, however, included a proposal for a 5% cut, I believe, in the salaries of Federal civil servants. Isn't that a concern in terms of the ability of the government to attract into the civil service the quality of employees in competition with private industry that are needed in today's environment?

THE HONORABLE JAMES A. BAKER, III: Well, we didn't think so or we wouldn't have proposed it. (Laughter) It's our view that...(Applause)...it's our view that the president is asking a lot of people to make some hard choices in the fiscal '86 budget. And he's calling for some spending cuts that are, in fact, not easy to make. If he's asking the American people to make some sacrifice there, it was our view that the Federal government employees ought to bear their fair share. They ought to participate. So we've asked for a 5% reduction in the pay of Federal civil service.

JAMES BURKE: Mr. Secretary, many commentators feel that the Treasury's proposals are inordinately biased in favor of consumption over savings. The U.S. has already one of the lowest saving rates of any nation in the world. In Japan it's almost 20%. Europe, it's better than 10%. And we're just barely over 6%. Do you think that these proposals favor consumption over savings? And if so, do you consider that to be sound policy?

THE HONORABLE JAMES A. BAKER, III: Well, we wouldn't want to favor consumption over savings unduly, Jim. And that's one of the things that we're looking at in examining each and every element of the proposal. You mentioned 401Ks, IRAs. We're looking at every element of the tax reform proposal to see what its effect is on not only capital formation but savings and investment as well.

VIRGINIA DWYER: With respect to the solution to the deficit problem, there was originally a great deal of discussion about a Balanced Budget Amendment to the Constitution and not much has been heard about that in recent months. Do you think that that will be revived at some point?

THE HONORABLE JAMES A. BAKER, III: The Balanced Budget Amendment? Yes, I think you'll hear, I think you will hear more of that from the president. That's something that he pushed quite hard for a year or so ago. As a matter of fact, my recollection is we got it voted in the Senate and we discharged it from the, through a discharge petition we got it out of the Judiciary Committee in the House, but we couldn't get it passed by the House of Representatives. The president believes very strongly in it. He spoke to it in the State of the Union. You haven't seen him out there with a national campaign with respect to it the way you did a year or so ago, but don't count it out.

JAMES BURKE: Mr. Secretary, as has been indicated, some in the business community have expressed their attraction to the overall direction of the Treasury proposal primarily because of the changes that would occur in the rate structure, and I think all of us feel good about that. We all know that there's going to be a lot of give and take and compromise on many of the provisions even after the revised proposals are introduced. For example, Senator Packwood has expressed interest in preserving some fringe benefits. Others have strong feelings about capital cost recovery and venture capital and so forth. So many parts of the overall package are so interrelated, doesn't it start to unravel? And how will Treasury respond when it must make the compromises beyond those already in view? What will happen to neutrality and most importantly to the rate structure? Where will the revenue come from?

THE HONORABLE JAMES A. BAKER, III: Well, one of the conditions that the president has put on us is that rates can be no higher; the highest individual rate can be no higher than 35%. As I mentioned in my remarks, it would be nice to think that we could have a pure economically neutral tax code, but we will be unable to achieve that. That should not foreclose or prevent us from making every effort, though, to achieve a reform that's as economically neutral as possible. Will there be tradeoffs? Will there be compromises? I'm sure there will be. There are with respect to any legislation. And I think that you'll see that go through this process. Hopefully, it will not unravel. I think we tend to lose sight of the fact that the president has really not, except for his

State of the Union speech, he has really not been to the country, if you will, on this issue yet. He still is working hard on deficit reduction and spending control and it's quite appropriate that that be taken care of first. But I really do believe that when the president does go to the country, you're going to see substantial grassroots support for an overall overhaul of the tax system.

VIRGINIA DWYER: Mr. Secretary, as we go through this difficult period of trying to bring spending under control and enact a tax reform proposal, could you comment on the initiatives within the Treasury Department to try and manage the inevitably heavy financing burden that will be involved during the deficit years currently underway to minimize the impact on interest rates, both their level and the degree of volatility?

THE HONORABLE JAMES A. BAKER, III: Well, the only thing I can say about that is that we have had, so far we have been able to finance the debt and the deficit without undue problem. I like to think that that will continue to be the case because I like to think that investment seeks quality and the Treasury offers quality. (Laughter) I believe that to be the case. And I don't anticipate quite frankly – assuming that we achieve the policy measures that the president has called for – that we're going to have any difficult financing the debt.

JAMES BURKE: A tangential question to Virginia's. The findings of the Wharton Econometric Forecasting Associates' study of the Treasury tax proposal and other historical evidence appear to suggest that interest rates will not fall as suggested by Treasury but rather that they will remain stable or rise. Would you care to comment on Treasury's conclusion to the contrary?

THE HONORABLE JAMES A. BAKER, III: Yes, Treasury's conclusion to the contrary is based on the fact that the Treasury proposal calls for indexing of interest, and that is one of the provisions that has received quite a bit of comment and criticism. The criticism comes primarily from the fact that it is not simple. It does not tend to simplify the tax code. It probably makes reasonably good sense, but there's a lot of, there is a lot of critical comment out there with respect to interest indexing. If you take that out of the Treasury's proposal, I don't think we would claim that as a mere consequence of tax reform interest rates will go down. And I don't mean to be saying we're going to take it out, I'm just saying if it were to come out.

VIRGINIA DWYER: With a former member of the Treasury Department at the Head of the Council of Economic Advisors, I wonder if you would care to comment on the role of the council in the current economic makeup of the administration.

THE HONORABLE JAMES A. BAKER, III: Well, the role of the council is to advise the president with respect to economic matters. It is, after all, the President's Council of Economic Advisors, and he will look to it and receive from it economic advice from time to time. (Laughter)

JAMES BURKE: Now we know what you meant when you said the Treasury attracts quality.

THE HONORABLE JAMES A. BAKER, III: I was talking about in its investments.

JAMES BURKE: In January of this year the President's Commission on Industrial Competitiveness issued its report, Global Competition: The New Reality, in which it called for the elimination of practices that are impeding the ability of U.S. companies to keep pace with the new reality of global competition. However, the Treasury proposal of last November calling for the replacement of the overall foreign tax cut limitation with a per country limitation would significantly increase the cost of overseas operations for U.S. companies. And by the way, this is one that I am interested in. (Laughter) The Treasury proposal seems inconsistent with the recommendations of the President's Commission on Industrial Competitiveness. Is there a compelling reason to include this provision in the Treasury's final proposal?

THE HONORABLE JAMES A. BAKER, III: Well, there are any number of provisions in the proposal, I suppose, that you could say run counter to the recommendations of the Commission on Industrial Competitiveness. I think, again, the answer to that question is in the abstract perhaps that provision does. The answer, I think, is if you're going to have tax reform, if tax reform is a worthy goal in and of itself, you've got to take a look at every one of these specific preferences, deductions, credits, and elements of preference that are out there to see whether or not you can keep them and still achieve an overall rate reduction – let me say it again – not only for individuals but for corporations as well. Let me mention one other thing about the Treasury tax reform proposal that some may not know. It calls for an interest; it calls for a deduction by corporations equal to 50% of dividends paid. It's the first step toward eliminating the double taxation of dividends. And many corporations have come to us and told us that they like that proposal quite a bit. Some of them say they don't like it so much, that they like the overall reform proposal, but they like that proposal quite a bit.

VIRGINIA DWYER: Mr. Secretary, in connection with the dividend deductibility part of the proposal, is that being viewed as part of the package that's under reconsideration with respect to the investment tax credit depreciation and other capital investment incentives?

THE HONORABLE JAMES A. BAKER, III: Yes, that's part of the original Treasury proposal. And as I indicated earlier, every element of that proposal, we are reviewing every element of that proposal with a view to making recommendations to the president, including that one.

JAMES BURKE: The cost recovery system described by the Treasury proposal has been criticized on the grounds it's less favorable than those of our principal trading partners and it would provide a positive incentive for American companies to move their manufacturing operations to Canada, Mexico, or offshore. Recent studies have shown that since the current cost recovery system was adopted in 1981, U.S. companies have pulled back from investing abroad and investment in the United States has increased. To what extent, if any, do you believe concerns with international competitiveness should be taken into account in developing the new tax system?

THE HONORABLE JAMES A. BAKER, III: I think that, I very definitely believe they should be taken into account in developing the new proposals and I've so testified.

JAMES BURKE: Okay. I'm not going to touch that one. What you're saying is that you don't really believe that the ACRS argument relates as directly to that question as...

THE HONORABLE JAMES A. BAKER, III: No, I think it does. No, no, what I'm saying is I think we very much, we very definitely have to look at the change that's called for in Treasury-1 with respect to ACRS vis-a-vis its effect on industrial competitiveness. And I have so testified.

JAMES BURKE: Thank you.

VIRGINIA DWYER: Mr. Secretary, if the efforts to achieve the reduction in the deficit through spending cuts fall short of what is an acceptable minimum, is it possible that there will be some consideration given to some kind of tax proposal separate from the tax reform proposal which would help to close the gap?

THE HONORABLE JAMES A. BAKER, III: No.

JAMES BURKE: Mr. Secretary, this is my last question – we'll let Virginia follow up. You've been so direct with your answers. (Laughter) Unequivocal. We understand that the sheer bulk of the effort that will be required in the House to draft legislation as comprehensive as that proposed including transitional rules will certainly carry us into the fall. Senator Packwood has indicated that his committee will wait for the bill to come over to the Senate before acting on it. This suggests that there will be difficulty in completing the process before 1986 which would take the Congress into an election year. What do you see as a realistic schedule? Is it likely that the legislation can be on the president's desk by year end?

THE HONORABLE JAMES A. BAKER, III: Well, we're going to make every effort to try and get it there, Jim. And as far as a schedule is concerned, what we're shooting for is announcement of the president's decisions sometime in late April or early May and the commencement of hearings in Ways and Means shortly thereafter. And it's our intention or our wish to try and complete the thing this year because as I said earlier this is the kind of issue that cross-cuts a lot of different directions. And if you don't get it done in the aftermath of a 49-state win, you may not get it done.

JAMES BURKE: Don't you look for early bipartisan support?

THE HONORABLE JAMES A. BAKER, III: We have to have bipartisan. This is, again this is the kind of issue that isn't going to fly without bipartisan support. But there's still going to be a lot of opposition and a lot of pulling and tugging. And it's our view that it's something we want to do this year. The president very much wants tax reform this year. The only other thing I'd say in response to your question, and I don't mean in any sense to speak for him, but you should check with Senator Packwood about waiting until there's an actual bill from the House before he does anything because I understand him to be a supporter of tax reform.

JAMES BURKE: You talked also earlier, Mr. Secretary, about the president going to the hustings and getting behind this. Are you confident that he in fact will do that?

THE HONORABLE JAMES A. BAKER, III: I am quite confident that he will do that.

JAMES BURKE: I suspect we will have tax reform then.

VIRGINIA DWYER: Mr. Secretary, I think that is an appropriate closing question.

THE HONORABLE JAMES A. BAKER, III: Thank you very much. (Applause)

CHAIRMAN DWAYNE O. ANDREAS: Thank you very much Mr. Secretary. I think that I can say for quite a large number of people in this room, referring back to the earlier part of your very nice presentation where you spoke about that wild hair that got you into the bar room looking for votes, many of us look forward to the day when maybe that wild hair will bother you again. As is our tradition, I want to present you with the real Big Apple. It's a gift of our, a token of our appreciation for the very fine presentation and the honor of having you here this evening.

THE HONORABLE JAMES A. BAKER, III: Thank you very much.

CHAIRMAN DWAYNE O. ANDREAS: And so the 309th dinner of the Economic Club of New York is adjourned. And if you will just give the Secretary about two minutes to get out of the room before we crowd the entrances as he has a plane to meet, we would appreciate it. Thank you very much.

End of Meeting