The Political Forum

A review of social and political trends and events impacting the world's financial markets

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HYPE AND RHETORIC ON THE POTOMAC

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This is the first Weekly comment by Mark Melcher, who has covered political and economic developments in Washington, D.C. for the past 20 years as an integral part of his work as a professional analyst of the pharmaceutical regulatory process. Mark will be our Washington liaison.

Those individuals who feel the Republic is only truly safe when Congress is on vacation have less than a month to wait before lawmakers go home for their summer break. In the meantime, there is really little to fear, as partisan politics increasingly paralyze an already near comatose legislature.

Talk of tax increases, the fiscal 1984 budget, and other economic issues will add to our supply of hot air throughout July, but no action is likely. While Congress is on its five-week break, White House sources indicate President Reagan will probably officially authorize establishment of a reelection committee. When Congress returns, around September 9, the presidential race should be in full swing, further reducing the likelihood that the Republican Senate and the Democratic House will reach any meaningful compromises.

On the tax front, an administration source told us he saw about a one-in-five chance of action on a workable alternative to the budget resolution's call for $73 billion in new taxes over the next three fiscal years. Our source was pessimistic despite Senate Finance Committee Chairman Robert Dole's (R, Kan.) call for a summit to include himself, the White House, and Ways and Means chief, Dan Rostenkowski (D, Ill.). Dole called the budget resolution "unbalanced and unworkable," echoing Rostenkowski's statement that Congress cannot possibly raise taxes that much.

The White House, according to our source, is not at all interested in a summit. “Let ‘em sweat,” he said—a statement that pretty well sums up the President’s apparent view that no action by Congress on taxes is better than any action, and that a power vacuum on the Hill helps concentrate power in the White House.

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Three possible resolutions of the tax issue come to mind...

Most Likely

Dole and Rostenkowski develop distinctly different approaches that are irreconcilable and the matter dies amid partisan cries that the other side is at fault.

Possible

Congress hammers out a compromise, after a Herculean political effort by both Dole and Rostenkowski. Such a ploy would be designed to save face for Congress. To work, however, it would have to be acceptable to President Reagan – i.e., it would have to contain minimal to zero tax increases in fiscal 1984 and 1985.

Least Likely

The committees comply with the budget resolution and send Reagan a $73-billion, three-year tax increase proposal. Even if this were to happen, President Reagan would surely veto it.

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Reagan has said he would go along with a $45-billion tax boost in fiscal 1986, but only if (I) the projected deficit in that year were larger than 2.5% of GNP, (2) the economy were growing, and (3) the bulk of his proposed budget cuts had been enacted.

The President holds the trump cards, and he is not looking for tax increases to reduce the deficit. Investors shouldn’t either.

On the budget side, we appear to be in for a lot of sound and fury, signifying very little. The one positive thing that will probably be accomplished is an agreement by Congress to delay by six months all COLA increases in non-SSA benefit programs — veterans’ pensions, government retirement, and so forth. Also, Congress is likely to go along with the President’s request for restraint in federal pay increases.

Eight domestic appropriation bills will be subject to veto battles, and most probably won’t pass, resulting in government by continuing resolution. The White House would be pleased with this outcome.

Most observers feel that the President will eventually accept a defense appropriations bill that is slightly higher than the budget resolution. This amounts to less than the President wants to get, and somewhat more than Congress wants to give. An 0MB spokesman told us that the net result will be a "spending track not much more than proposed by President Reagan, largely because of the defense cuts." What this means, he said, is that "absent revenue increases, we will have $200-billion deficits as far as the eye can see."

There are strong indications that this 0MB view — shared by Treasury Secretary Donald Regan and CEA Chairman Martin Feldstein — is not endorsed by President Reagan. He reportedly feels that very strong economic growth is the key to the deficits and other economic ills and is very good politics as well. President Reagan does not appear to share those advisers' fears of strong economic growth. It seems almost a visceral reaction for him — a booming economy means more jobs and plenty of money to finance more growth and is inherently good.

As to the deficits, Reagan certainly would like to be done with them as much as anyone. On the other hand, the politician in him must realize that there is a certain perverse political benefit to large deficits at this time.

O First, they severely hamper Democrats who want to offer their traditional fare of more federal entitlement programs. To do so, they must also ask for politically unpopular tax increases to finance the programs. Deficits also have the effect of starving the existing Democratic programs that Reagan has detested for so long.

O Additionally, the President knows it will be difficult for the Democrats to use the issue of large deficits against him, since the only alternative they offer are higher taxes or less government spending — not particularly savory offerings.

Thus, if President Reagan has his way, and he usually does, it's "damn the torpedoes, full steam ahead," as far as the economy goes.

Federal Reserve policy will be at the forefront of Congress's economic rhetoric over the next two weeks. Chairman Paul Volcker's Senate confirmation hearing for another four-year term as the nation's top banker is Thursday, July 14. This is the day after the Federal Open Market Committee's two-day monthly meeting — described by many observers as one of the most important, both politically and economically, in years.

The following week, Volcker again appears before Congress to outline his economic assumptions and monetary goals as prescribed by the Humphrey-Hawkins Full Employment Act. This is a semiannual affair that usually sparks the lawyers in Congress to new heights of pomposity on monetary and economic matters.

Heightening the interest of publicity-conscious Congress members in the Fed issue, the *Washington Post* last week rushed in where reasonable angels would surely have feared to tread, confidently predicting the FOMC would raise the discount rate from 8-1/2% to 9%. The claim was based on conversations with "Federal Reserve sources." The White House responded to the *Post* story with a strong statement that the President would not like to see the discount rate increased, although he would not object to seeing money growth slowed somewhat.

Although it received a great deal of attention, the *Post* story was taken with a large grain of salt, considerable by most close Fed watchers — not because it will necessarily prove to be wrong, but because it is unlikely that anyone at the Fed could confidently know a week ahead how such a tough call will be made — much less tell the Post. In any case, the Post toned down the confidence level of its statement in subsequent days—and now waits with us mortals for the real outcome.

Most Fed watchers view the debate with some amusement, pointing out that the Fed has been tightening since late May, and that a discount rate boost would be largely a following move, not a leading one. They point out that the last Pooh-Bah had hardly boarded the helicopter at Williamsburg following the big May economic summit before the Fed boosted the Federal funds rate by 50 basis points. And, they point out that another, similar hike has occurred since. A boost in the discount rate would thus be more of a political statement than an economic one, they maintain.

If this is true, it seems likely the Fed will wait awhile before increasing the rate—if it does. The political message that the much-discussed boost would send would clearly be strongly negative, both to the White House and to the international financial markets.