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A Speech to the Annual Correspondents Conference of the Centerre Bank, St. Louis, Missouri, November 8, 1984

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What difference will the election results make to the American economy? Will January 1985 usher in a new era of economic good feeling? Or will it merely offer a small window of opportunity to make a few important changes?

In a burst of nonpartisanship, I would like to begin by conceding that few of our economic ills will be cured in the coming 12 months, or in the next four years. But surely, we will have opportunities for initiating important changes and for making tough decisions.

Fundamental Changes in the Business Environment

To begin with, we need to remind ourselves of the fundamental changes in the economic environment that have occurred in the past four years. In our preoccupation with budget deficits -- and I will get back to that a little later -- we have overlooked developments that have more basic effects on the day-to-day economy.

For example, since January 1981, we have seen a more positive governmental attitude toward mergers between large corporations. If you favor this development, you will say that it is a more modern and enlightened government position. But if you do not, you may label the government's willingness to go along as a more permissive attitude. Whatever your view, the important aspect is that, during the past four years, we have witnessed an unprecedented wave of mergers which government has allowed to be carried out.

Remarkably, this did not require any special laws passed by the Congress. Rather, the President appointed a new Attorney General, a new Assistant Attorney General for the antitrust division, and a new Chairman of the Federal Trade Commission. Moreover, I believe that this favorable attitude toward mergers between large companies will, to some degree, continue beyond the Reagan Administration.

It is becoming clear that many U.S. companies increasingly compete in global markets. Thus, many firms that are statistically labeled "oligopolists" because they dominate domestic sales and production of a given product, face tough competition from large foreign firms. When we compute their world market shares, we find that they are much smaller than the conventional measures of an industry's domestic "concentration."

A related legal matter is the changing composition of the Supreme Court. With many of the Justices in their middle or late seventies, a major round of appointments is likely within the next four years. Thus, President Reagan will have the opportunity to influence the direction of the Court for a long time to come. After all, on average, the current justices have served on the Supreme Court for over 13 years. With several more Reagan appointments, the present precarious conservative majority will likely be solidified -- although the independence of the judges makes such predictions hazardous.

Another key area of the economy that has been ignored because of the preoccupation with budget deficits is labor-management relations. Although few people realized it at the time, one of the most important labor events in the past decade was the President's tough response to the illegal PATCO strike. Firing the air traffic controllers was a decisive move that signaled a fundamental turn in American labor-management relations.

This shift may have been the main reason that the postal unions did not seriously consider striking. But the repercussions of the President's action extend to the private sector as well. The signal is strong and clear: No longer will government get involved in disputes between companies and their unions. In many past administrations, the federal government put pressure on management to settle promptly with unions, and the result was escalating wage settlements. Our high-cost steel industry is a cogent example of the dangers of such government intervention.

In contrast, we have been witnessing a remarkable slowdown in union demands. This, of course, has helped reduce inflationary pressures. But what is most fascinating is that it has helped the average worker. He or she is now experiencing increases in living standards -- up 2 percent during the past year. This compares favorably to the declines in average real earnings during the years when wage rates were rising far more rapidly.

The new economic environment is truly pervasive. It extends beyond the two important examples that I have just given. What we see is a sharply changed interpretation by government of its role in society. The Reagan Administration -- as it deals with individual issues -- is giving more weight to private initiative and less to government involvement than preceding administrations, Republican or Democratic.

This change in basic outlook is reflected in positions on many specific issues. Thus, in dealing with the problem of the deficit, Ronald Reagan opposes tax increases (paid, of course, by the private sector) and focuses on cuts in public-sector spending, especially for the social programs that contribute little to a stronger economy.

Future Changes in the Economic Environment

What about the next four years? Unless external circumstances change dramatically, I doubt if many major new domestic initiatives will be developed, at least in the White House. The President seems to be satisfied that his economic program is working. Taxes have been cut, inflation is lower than almost anyone anticipated, and production, sales, employment, and profits are all continuing to rise. Thus, in a second term, the major attention of the White House can and probably will shift, as it already has in part, to foreign policy matters. The rapid arms buildup will continue. Relationships with the Russians continue to be difficult, but that area will also get greater attention than in recent years.

In a second term, a President and his staff will start thinking about how he will go down in the history books. Trimming government spending is not a likely way of creating a memorable Presidency. But if President Reagan succeeds in persuading the Russians that they cannot keep up with the American Jones (or rather Weinberger), perhaps then they will agree to real arms reduction. That is what the President hopes will happen. If he can achieve that, Ronald Reagan will deserve an important place in history.

As for those budget deficits, the proposed constitutional amendment to require an annually balanced federal budget is looked upon by the White House as the major response. Given the short-term difficulties of cutting specific budgets, the constitutional approach is regarded as the only satisfactory long-term solution to the fiscal problem facing the United States. But, because of the time it would take before such an amendment would take effect, that would mean little action on the budget deficit during the next four years.

A cynic might note that the current attractiveness of the balanced budget amendment is that the tough decisions can be postponed. Meanwhile, however, Congress may take the lead in budget cutting. The results, I suspect, will be as modest as they have been in the last several years -- cuts in military programs offsetting increases in civilian outlays.

During periods of economic growth, such as now, when incomes and employment rise, people are content with the status quo. Very little support can be generated for the painful actions involved in budget cutting. Of course, when business turns down, many advocates of economy in government lose heart, and agree that recession is not the right time for curtailing federal outlays. Excuses for inaction are always present, and the trend of rising government spending continues almost unabated.

Under these circumstances, I anticipate that tax reform in the next four years will resemble what we called "revenue enhancement" a few years ago. That is, despite the rhetoric, the tax burden on the average citizen will rise. However, that burden will remain below the level of 1980.

We will hear a great deal about tax reform as 1985 unfolds. Surely there is no shortage of proposals -- flat taxes, value-added taxes, expenditure taxes, and gross income taxes. President Reagan has vowed not to raise income tax rates. That language provides considerable flexibility. It allows, of course, for the introduction of a value-added tax (VAT) or expenditure tax, or some other tax based on what you consume rather than on what you earn. Each of these alternatives exempts saving -- and thus promotes investment. A VAT promotes efficiency because -- unlike the income tax -- it taxes costs and profits equally. Nevertheless, I expect that opposition to any new tax will unite both liberals and conservatives. Although their motives will differ, that combination should keep these proposed innovations from being enacted.

It is more likely that a second Reagan Administration will move toward a flatter income tax structure. That means, as the advocates point out, broader brackets, lower rates, and simpler forms for taxpayers. The flip side of this approach, however, is that the tax base must be broadened in order to maintain the total flow of revenue to the federal government. Although flat tax proponents soft pedal this aspect, it is vital. The extent to which tax rates can be cut depends primarily on how much the tax base can be expanded. It is not merely an esoteric matter of closing some technical loopholes discovered by tax attorneys and accountants. Here are some of the suggestions that have been offered· limiting the amount of personal interest and taxes that can be deducted from taxable income; taxing items not now taxable, such as employer-paid fringe benefits; and taxing Social Security and unemployment compensation.

The two flat tax proposals that are now receiving the most attention are the FAIR tax suggested by Senator Bill Bradley (D-NJ) and Congressman Richard Gephardt (D-MO) and the FAST tax developed by Congressman Jack Kemp (R-NY) and Senator Bob Kasten (R-WI). In order to maintain the flow of revenue ("revenue-neutral" being the current buzzword), both bills would eliminate that key incentive for economic growth, the investment tax credit. The result would be a weaker economy and higher levels of unemployment than would result from keeping the existing tax system. Hopefully, some other "loophole" will be closed instead.

If Democratic Senator Bill Bradley and Republican Congressman Jack Kemp can combine their two "flat tax" bills, and thus ultimately join forces, that would substantially increase the possibility of Congressional action. The likelihood of that happening will depend on how two conflicting forces are balanced. I am referring to the reluctance to take any more action on the tax side until we can control the growth of government spending. And, on the other hand is the fact that it is a lot more fun to work on tax cuts than on the tough spending decisions. In any event, I expect that we will continue to suffer triple-digit deficits throughout the 1980s. I say that not to justify such action, but in the interest of realism.

The Current Economic Outlook

Now let me turn to the fearless forecast: 1984 will be a peak year for the performance of the American economy, with growth averaging 7 percent and inflation a modest 3 percent. Most forecasters are predicting for 1985 a combination of less growth and more inflation than in 1984. My crystal ball shows 3 percent growth for next year and 4 percent inflation. Although not nearly as good as 1984, these numbers describe a respectable year compared to the combination of recession or slow growth and high inflation that characterized so much of the 1970s and early 1980s.

Although fiscal policy seems to be remaining virtually on automatic pilot, I believe that we can expect a turn in monetary policy for the next several months. Since June, the growth rate of M1 (the most closely watched measure of the money supply) has averaged about 1 percent. M1 is now in the bottom half of the Fed's target range for money growth. All this points up to a likely expansion in the growth rate of the money stock over the next several months. Hopefully, the Fed will stay in its target range and avoid its traditional response -- doing too much too late. My forecast for 1985 implicitly reflects the belief that the Federal Reserve will provide enough liquidity in the economy to keep the current recovery going, but that we will begin to pay an inflationary price in the future. The result will be upward pressure on interest rates. However, the slowdown in the economy in 1985 will mitigate that pressure.

Candidly, we must acknowledge those serious economic problems that continue to bedevil the country and that inhibit government policymakers -- stubbornly large budget deficits, rapidly rising trade deficits, and unusually high real interest rates. Many industries especially sensitive to high interest rates or foreign competition will not fully share the growth experienced by business as a whole. Steel, automobiles, housing, and agriculture are clear examples of such vulnerable sectors.

In fact, late in 1985, I suspect that we will begin to hear more about the possibility of recession. Certainly, business downturns have not been outlawed. But neither is it written in the stars that 1986 will be a recession year. Much will depend on the Fed as well as the private sector reaction to both monetary and fiscal policy changes. Sensible contingency planning, I suggest, would prepare business and investors alike to be ready for such a change in the economic outlook. The economic traffic light in late 1985 will change from green to flashing yellow.

Looking beyond the next year or two, I see an American economy which is more cost-conscious, more productive and hence, more competitive -- both at home and abroad. The shift in the emphasis in government policy -- from its traditional public-sector orientation to the reliance on the private sector -- strengthens the business system in a fundamental way. And that is, I believe, both a realistic and upbeat way of looking at our economic future.