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THE POLITICAL ECONOMY IN PERSPECTIVE

THE OUTLOOK FOR A CAPITALIST RENAISSANCE

by: Paul Craig Roberts

The balanced-budget opposition to tax cuts is collapsing with the onset of recession. As a result, the outlook for capitalism is both more propitious and more dangerous than before. It is more propitious because the prospects for strengthening incentives are greater. It is more dangerous because the left-wing will push for more income guarantees, public service employment, and centralized allocations as the response to recession in order to prevent its political base from being swept away by the rising tide of prosperity that a restoration of individual incentives would bring.

To enhance the chances of a capitalist renaissance, the tax reduction movement needs a political manager. The advocates have done their job of making tax cuts a major public policy issue. What is needed now is a political leader who can convince the people that he can successfully manage the restoration of incentive. This will require the movement's shock troops to tone down their rhetoric and allow others to join the cause.

For a capitalist renaissance, it is not enough to restore domestic incentives. The "weakness tax" brought on by the decline in the American economic, military and diplomatic position must be repealed too. This will require leadership on a grand scale. In recent years, the cost of leadership has been rapidly rising. Only a man facing his final challenge in life would be likely to assume the burden.

June 3, 1980



THE OUTLOOK FOR A CAPITALIST RENAISSANCE

THE POLITICAL BACKGROUND

Within a few years "supply-side" fiscalism — the economic approach that stresses incentives rather than aggregate demand as the focus of macroeconomic policy — has enjoyed astounding success. That a new approach to economic policy so rapidly gained acceptance indicates a widely perceived need for a change of direction.

It was only in 1975 that Rep. Jack Kemp (R., NY) sprang the new economics on the Congress in the form of his Jobs Creation Act, which raised the after-tax rate of return to savings and investment, and thereby, increased the reward to labor. The logic of the bill combined well with the growing concern about productivity, and the bill quickly picked up 120 co-sponsors in the House. But the movement was stymied because Rep. Kemp had no committee base from which to push his bill.

By the fall of 1976 when the Democrats returned from the elections and called for a Third Budget Resolution in order to provide more stimulus to the economy, the "supply-side" movement had gained a legislative base in the minority of the House Budget Committee. Now there was a legislative forum from which to offer supply stimulus as an alternative to the Democrats' Keynesian fiscal policy of stimulating demand. To avoid being labeled spokesmen for "big business," Republicans adopted generalized personal income tax cuts, and the Republican substitute to the Third Budget Resolution for fiscal Year 1977 was the origin of what became the Kemp-Roth bill.

Representatives Marjorie Holt and John Rousselot kept the pressure on Keynesian fiscal policy by continuing to offer tax cuts as substitute budget resolutions. By 1978 when the Holt amendment (across-the-board personal income tax rate reduction combined with spending limitations) twice came within several votes of passing the House, and the Nunn amendment (same) passed the Senate, "supply-side" fiscalism had become a major public policy issue.

As a last resort for holding tax cuts at bay, congressional big spenders adopted the austerity language that Republicans had abandoned and began emphasizing a balanced budget. This was a good ploy since it played to certain Republican economists, but it was a stalling measure at best. With the onset of a recession, the call for stimulus will toll the end of the balanced budget diversion.

As tax cuts again move to center stage, their position will be stronger. With leadership from Senators Sam Nunn (D., Ga.) and Lloyd Bentsen (D., Texas) joining that of Senator Roth (R., Del.) and Representatives Kemp (R., NY) and Holt (R., Md.), the new economics ceased to be a partisan issue. As Senator Bentsen said in the Senate on April 23, 1980, "The Joint Economic Committee, which I chair, has tried during the past two years to move our nation's economic policies along the paths suggested by "supply-side" theories."



This is a positive development because it means that Keynesian demand management, which has so seriously damaged the economic position and potential of the U.S., has been intellectually defeated. It is also on the verge of being defeated on the power-politics level as well. The bureaucratization of the economy via demand management is still enshrined politically in the Congressional Budget Office and the budget committees where the Keynesian emphasis on expanding aggregate demand has served well the spending proclivities of congressional liberals. But the departure of Senate Budget Committee chairman Ed Muskie (D., Maine) to become Secretary of State weakens the liberals' ability to continue to use the budget resolutions as a method of expanding their spending constituencies.

People are wondering why Senator Muskie would give up the chairmanship of the Budget Committee and his Senate seat to be Secretary of State for perhaps only 9 months. Some of Muskie's colleagues speak of the Senator's expressions of frustration over the budget process. And frustrated he may well be. The big spenders who set up the congressional budget process intended it to justify spending deficits in terms of Keynesian fiscal policy. When Senator Muskie sat himself in the saddle of this spending horse, little did he know that it would be tripped by the new "supply-side" economics. But that's what happened.

The final blow came when Senator Hatch (R., Utah) made public a memo from the Budget Committee's staff director to Senator Muskie describing the behind-the-scenes maneuvering to frustrate Senator Hatch's request for Budget Committee hearings on the econometric models used by the Congressional Budget Office to justify ever more spending.¹ If the models could withstand an examination, CBO director Alice Rivlin would have been glad for the opportunity of public hearings to get Senator Hatch off her case. But the Budget Committee memo reported that Ms. Rivlin "doesn't really want to have hearings and would like us to put Hatch off somehow."

It may well be clear that Senator Muskie left the Senate in part because, over the past three years, he had lost the battle against "supply-side" economics. The once powerful chairman of the Budget Committee was reduced to backroom maneuvering to fend off a junior senator from the minority.

Senator Muskie's defeat in his own committee symbolizes the larger scale defeat of Keynesian fiscal policy. It signals the end of the expansion of government under the auspices of demand management stabilization policy. This defeat of the liberals does not guarantee a "supply-side" sweep to victory. With defeat and confusion in the liberal ranks, the authoritarian left now has its chance too.

In the event of a bad recession the public, which has been willing to support a "supply-side" policy since 1978, could turn instead to government guarantees of position and livelihood. People are more supportive of tax cuts when they are employed, and the incentive effects are more powerful when the economy is moving upward and confidence and "the animal spirits" are high. By blocking tax cuts for two crucial years, the liberals have increased the chances for more direct government intervention in the economy, intervention that would take the form of increased protectionism, subsidies, and national economic planning -- all in the name of "supply-side" economics, of course. The emphasis on production and the terminology are similar, but in place of incentives the left has the government authority. It is still the same old struggle of a free society versus the paternalistic state.

¹ The Joint Economic Committee began hearings on the econometric models on May 21. In the time since February 1977 when I, as chief economist (minority staff) of the House Budget Committee, publicly called the models into question, both Michael Evans, who developed the Chase model, and Otto Eckstein, proprietor of the DRI model, have abandoned their former demand-side perspective and developed supply-side models for the Senate Finance Committee and the Joint Economic Committee respectively.



NEEDED: A MANAGER TO OVERSEE THE RESTORATION OF INCENTIVES

The chances for capitalism will be greater if Ronald Reagan can avoid being positioned as a tax cut advocate and assume instead the position of a responsible manager who can successfully preside over the restoration of incentives. Advocates make issues, and in so doing take on an extreme image. People are uncomfortable with extremism in a presidential candidate. The voters are not looking for a President with the personality of an advocate, who might lead them into all sorts of new and untried ventures. They want a man who knows how to manage what needs to be done.

At this stage of the game it is pointless for Mr. Reagan to assume the risks of an advocate. Instead, he should simply accept as self-evident the fact that tax reduction has been placed squarely on the national agenda by politicians in both parties — men and women like Kemp, Holt, Rousselot, and Jim Jones in the House, and Roth, Hatch, Hayakawa, Bentsen, Nunn, and Long in the Senate. He can cite the last two annual reports of the Joint Economic Committee of Congress, and he can point to the recommendations of the "Conference on U.S. Competitiveness" held last April at Harvard under the sponsorship of Harvard University, the Senate Subcommittee on International Trade, and the New York Stock Exchange.

The recommendations of this important conference show how widespread are the acceptance of "supply-side" economics and the need for greater after-tax rewards. Held in the original seat of American Keynesianism and in the presence of a full array of Harvard professors and deans, the participants — a group of congressional, business, academic and labor leaders — concluded that the restoration of the American economy required a "supply-side" economic policy for the 1980s.

Overall the conference recommended aggregate tax reductions of about \$100 billion over the 1981-83 period split evenly between business and individual reductions. Many felt that even a cut of this magnitude was insufficient compared to the projected growth of revenues over the same period. Furthermore, the conference recommended that "a tax cut should take precedence over a balanced budget" — which is a way of saying that if a balanced budget is important it can be achieved by cutting spending.

Moreover, this was not a conference staged by supply-siders or held for the purpose of endorsing "supply-side" economics. The conference participants began with a concern with the U.S.'s declining competitiveness in the international marketplace, and as the solution to the problem they endorsed the restoration of incentives at home.² Echoing President John F. Kennedy ("a rising tide lifts all boats"), Senator Ribicoff (D., Conn.) declared that "increasing productivity is good for every segment of society." That statement from a leading liberal cleared the deck of any argument about who benefits from tax cuts.

Otto Eckstein, professor of economics at Harvard and president of Data Resources, Inc., reported that the absence of a "supply-side" policy during the last 8 years had increased the core rate of inflation, and that growth in the personal income tax burden had driven 2 million people out of the work force. Martin Feldstein, professor of economics at Harvard and president of the National Bureau of Economic Research, reported that the tax burden on non-financial corporate income was one-third higher today than during the 1960s.

² Senator Bentsen made it clear that it is our competitors who benefit from high and rising U.S. tax burden. As a result of bad tax policy, "We are asking the American worker to do tomorrow's job with yesterday's tools." Pulled down by lagging productivity, we are fast becoming "an also-ran in the race for economic opportunity." In other words, the large tax and regulatory wedge reduces the ability of American labor and products to compete.



With this kind of national support for incentive tax cuts, candidate Reagan has no need to be defensive about his endorsement of "supply-side" economics. At the same time it is clear that a movement with such broad support needs a manager who the people trust with the issue, not another advocate.

REPEALING THE WEAKNESS TAX: A CHALLENGE TO LEADERSHIP

A refurbishing of production incentives would send the world a message that we believe in our system and intend to restore our position. It would be an important first step toward the repeal of the weakness tax.¹ Holding a commanding position in the world is an asset, a form of wealth; but misled by certain intellectuals and policymakers who are distrustful of American power, we have squandered ours. In the process we have created such a power vacuum that Castro has taken up the practice of gunboat diplomacy in our offshore waters, sinking a Bahamian patrol boat and buzzing our Coast Guard rescue helicopters. Little wonder that the Soviets are on the move in areas beyond the reach of our deteriorated military and diplomatic posture.

Weakness begets weakness, but strength does not always beget strength. A powerful position is valuable, so it has to be fought for, while weakness can be had for the asking. Our relative decline accrues to the advantage of others, and their interests now stand between us and the restoration of our position. The world will not simply stand by idly while we re-assert our role. Therefore, even if we succeed in restoring the domestic economy, that achievement would not guarantee the resurgence of our role as world leader.

There are many national egos that want to enjoy the international stage. The French, for example, relish their bilateral dealings with Moscow, a development brought about the decline of American power. Others of our allies, both from the standpoint of self-interest and national prestige, find a one-to-one relationship with Moscow tempting. Disarmament advocates encourage these tendencies, because they believe they undermine NATO, and will result in the withdrawal of our military forces, thus reducing the possibility of a U.S.-Soviet conflict over Europe.

It is not just major nations like France who are finding it easier to ignore American interests. The international success of a tiny offshore country like Cuba as a colonial power — in spite of its domestic economic failure — has encouraged even stateless "governments" like the PLO to adopt a stance of dealing with the U.S. on equal terms. The rise of Arab oil power is itself a direct result of the "shaming of America." In the eyes of the world, America suffered shame as a result of cultivating a negative racial image here at home, defeat in Vietnam, and an American President driven out of office.

Not only is position once lost hard to regain, but long-established American attitudes will make it difficult for any President who attempts to lead in that direction. Americans view shame as a useful tool employed to achieve self-improvement. From this perspective, leadership consists of stressing our shortcomings in order to correct past failures and right past wrongs.

This makes for a power machine of domestic reforms. But from the viewpoint of outsiders, when the piecemeal indictments of our economists, political scientists, sociologists, historians, theologians, and ecologists are added together, the result is a total indictment of America. The U.S. cannot lead the world when it appears so dissatisfied with itself.

¹ For the concept of the weakness tax see Paul Craig Roberts, "Taxation in 1980," H.C. Wainwright & Co., Economics, January 14, 1980.

A President who tries to lead by focusing on our achievements and successes will run afoul of the "reform machine," which demands ever more corrections of past wrongs. The only way he can protect himself from constant attacks in the media is to be constantly leading campaigns against American shortcomings. Otherwise he will be put down as jingoistic and "unconcerned."

The internal use of shame as a tool of reform presents a dilemma to the restoration of American leadership. Constant shaming and reforming present an image of constant unworthiness. How do we lead the world when we are so unworthy?

Hooked on the horns of this dilemma, we give credence to Soviet and Iranian accusations that we do not have a decent and fair society. We ourselves created, through self-criticism, the image of "the American devil," about which the Ayatollah now rants and raves.

Many Americans today don't understand shame and its influence on position in the world. But the Saudis, for example, understand it well. To see the contrast consider the recent flap over the TV film, "Death of a Princess," first shown in Britain and then on American public television.

The Saudis strongly objected to the film, but the reasons for the Saudi objections escaped the American media, which has yet to fathom the consequences of the shame it has brought on its own country by overdramatizing American wrongdoing. The *New York Times* simply saw "a hypersensitive Saudi Arabia," annoyed by a film in favor of women's rights, trying to exercise censorship over American television. On May 14, 1980, in a typical editorial the *New York Times* crowed: "The sky is still in place. The Republic and its oil supply are still intact. And more to the point, after the broadcast of 'Death of a Princess,' so is national honor."

That is probably an incorrect assessment. First of all, there is a difference between censorship and an effort to persuade the media to use a little judgment. After all, a great deal is at stake. The Royal House of Saud is about all that remains of a western presence in the oil-rich areas of the Middle East, and in the mind of the orthodox Moslems the royal family is responsible if there is any public dishonor of Saudi Arabia.

To Saudi eyes the film brought shame upon their country: first by portraying women of the Royal House as promiscuous and, second by subjecting Saudi values to harsh criticism by outsiders. The inability of the rulers to fend off the public disgrace of Saudi Arabia at the hands of the foreigners has brought disrepute upon the House of Saud, and further eroded the legitimacy of its rule.

What did we gain from risking the honor and position of the Saudi royal family? According to the media, we have achieved a confident public television system that intends to be an independent medium of information. But independent of what besides common sense and consideration of the sensitive position of an important ally?

The media does not understand the damage that has been done. Schooled for decades in the use of criticism of a propagandistic nature to pressure our own society toward reforms and progress, the American media is used to de-emphasizing our own achievements and position. Therefore, it thinks nothing of risking the image of a "backward" ally.



The Saudis realize that you can't lead if you are under constant attack, but this elementary fact has not received much attention here at home. Scheming against our own society (in order to reform it) instead of against our adversaries, the opinion leaders contributed much to blurring the distinctions between the U.S. and our opponents. Only a nation that employs shame against itself could have missed, as the U.S. has done, the opportunity to refurbish its image presented by the massive emigrations over the past year from communist-ruled countries.

People are fleeing to America, not from her. But this expression of confidence, from outside, in our values and institutions makes many liberal reformers uneasy. The U.S. is supposed to be a white racist society in need of reform; yet vast numbers of non-whites are leaving their own kind to flee to our shores. Confused, the dichards explain away this flood of refugees from real tyranny and barbarism as remnants of the old order and former businessmen who can't adjust to the new communist values.

Such a perspective precludes turning the failures of our opponents to our own advantage. Nowhere is this more clearly seen than in the recent events in Miami. In the same week that tens of thousands of Cubans were pouring into the city expressing joyous gratitude for the opportunity to partake of America, the city's black American residents went on a murderous rampage proclaiming that "America is a lie." No one in the media asked why, if the Cubans are deceived and America is a lie, Miami's blacks weren't streaming in the opposite direction?

Instead, the beating deaths of hapless white motorists, who were pulled from their cars as they happened by, were treated by the media as evidence that America has "a long way to go" before it has cleansed itself of its unjust treatment of minorities. In other words, the racial murder of whites was portrayed as the result of accumulated frustration with the evils of white society.⁴

Reassured that America is still in need of reform, the Administration resumed an unfriendly stance toward the refugees from communism. President Carter declared a \$50,000 fine and a 10-year prison sentence for any American who dared help people escape from Cuba. In former times such Americans would have been seen as heroes. Today they are criminals.

The point of these remarks is not to denigrate, but to bring into full view the leadership problem faced by any President who attempts to refurbish the partly tangible, partly intangible asset known as "position."

The loss of position combines with our self-denunciatory ethic in a way that raises the question whether we have lost the ability to select our own President. It is now possible that the Soviets, by manipulating international politics, can help re-elect or defeat an incumbent President. For example, the Soviets could make President Carter look very good by helping him obtain the release of the hostages. Or they could "give in" to his pressures and begin withdrawing troops from Afghanistan just prior to election, only to reverse their action on some pretext after the election.

⁴ The Attorney General of the U.S. responded to the breakdown of law and public safety in Miami by excusing the black rioters: "There is a great perception of injustice, which has brought a sense of frustration and rage." That is a blanket justification for further rioting that no government official of a country not intent upon shaming itself would ever have issued.



On the other hand, they could continue to serve President Carter foreign policy humiliations and drive him from office, relying on the hostility of the liberal media toward Ronald Reagan to tie up the machinery of government for four years.⁵ They may even gamble that the media hostility toward Reagan would seize the slightest excuse to drive yet another American President from office, thereby eliminating the U.S. as a principal contender for world influence.

Without help from the media no American President can any longer survive the Soviet's power to manipulate international politics. In an inclement and brutal world, the loss of position is as costly to a nation as it is to a Mafia family. It is not too late to repeal the weakness tax, but it will require a radical change in American perspective together with a radical change in domestic economic policy.

⁵ An April 23, 1980, editorial ("On Wisconsin") in the *Washington Post* reveals a lot about the attitude of journalists toward Ronald Reagan. The editorial sets up the reader's mind the expectation of "a major foot-slip by Gov. Reagan" by designating George Bush as the candidate-in-waiting with a lock on the "standby" position. However, Senator Kennedy, who was much closer to Mr. Carter in delegates than Bush was to Reagan, was written off with "Pennsylvania could very well be the last official act of Senator Kennedy's challenge to Mr. Carter." Why did not the *Post* perceive Senator Kennedy also to have a lock on the "standby" position? It would seem, judging from the numerous policy flip-flops of Mr. Carter, that the public should expect at least an equal chance of a "major foot-slip" by the President. Is the answer that by focusing expectations on Gov. Reagan to commit a blunder, the heightened tensions will turn his slightest goof into a major issue which the media can use to hang him? For another example consider that at a time when President Carter was daily reversing his policy positions toward Israel and Iran and Gov. Reagan was trying to raise important issues, the network evening new chose to make a big issue out of Reagan's ethnic joke.