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Supply-Side Inflationism

by Leland B. Yeager

Supply-siders deserve to be congratulated for restoring some old truths to a position of influence on policy. Basically, wealth comes from production, not from demand. Given a properly functioning monetary system, output of particular goods and services constitutes demand for other (noncompeting) ones. Incentives are important to production—incentives to work, save, invest, bear risks, improve production methods, and launch new products and enterprises. Burdensome taxes and regulations erode these incentives and hamper the creation of wealth. *Marginal* rates of income tax and capital gains tax are particularly important, for they determine how much of an extra dollar the earner can keep. Furthermore, taxes are costs and in certain circumstances can actually contribute to price inflation.

Unfortunately, the messages of several prominent supply-siders have verged the irresponsible. In their own diverse ways, they have come close to preaching complacency about federal budget deficits and inflationary dangers.

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With some, outright politics is joined with dubious economics. In early May of this election year, Treasury Secretary Donald Regan, disavowing the contentment with monetary policy that he had expressed only a few days before, publicly blamed the Federal Reserve for rising interest rates. Given the current low rate of inflation, he said, the Federal Reserve had been restricting the growth of bank reserves and the money supply too tightly. Earlier, before a congressional committee, Secretary Regan had betrayed odd notions of how one learns economic theory. He recommended throwing away the February 1984 report of the Council of Economic Advisers. "I have 35 years of experience in the market. The CEA has none. . . . Experience in the marketplace is a lot more valuable than time spent in the library."[1]

"Supply-siders have come close to preaching complacency about federal budget deficits and inflationary dangers."

Paul Craig Roberts, a former official in the Reagan-Regan Treasury, has lately been complaining about "inflation hysteria" and "deficit hysteria."[2] As Leon Festinger's theory of cognitive dissonance explains, someone confronted with a fact or prospect carrying unwelcome policy implications tends to believe that worry over it is mere "hysteria," after all.

The theory of supply and demand suggests that the federal government's strong demand for credit to cover its deficits makes interest rates—the price of credit—at least slightly higher than they would otherwise be. Roberts, however, cites statistical studies suggesting that if there is any relation at all, low rather than high interest rates have historically tended to accompany deficits.[3] Yet this finding means little if past business recessions were helping to depress both tax revenues and interest rates at the same time.

Supply-siders maintain, similarly, that history shows no definite connection between government deficits and price inflation. This fact, however, is hardly reassuring. Of course small or large deficits in particular years are not accompanied or followed by low or high inflation rates in the same or the following years in a definite, stable pattern. The relation may well not be mechanical and precise enough to show up in time-series correlations. Government deficits affect price levels not so much directly and contemporaneously as through their impact on the quantity of money; these monetary consequences are unpredictable, or may sometimes even be avoided. (More will follow about how deficits can promote inflation indirectly.)

In his *Business Week* columns[4] Roberts tries to talk away large deficits themselves in the manner suggested by Professors Robert Eisner and Paul Pieper, whose work he cites with approval.[5] Those authors argue, in effect, that partial repudiation of the national debt through its decline in nominal market value as interest rates rise and the value of the dollar declines should count as a kind of government revenue; this would make the *real* budget deficit and its real stimulatory effect smaller than unadjusted numbers suggest.

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Editorial

Policy Ideas for the Next Generation

This fall's presidential campaign seems to be shaping up as a very ideological liberal-conservative battle. President Reagan will defend conservative policies across the entire range of economic, social, and foreign-policy issues, while former Vice President Mondale can be expected to advance liberal alternatives in each area.

The ideological nature of the fall campaign is a reflection of the increasing consistency of the two major parties. While there remain dissidents of varying stripes within each party, the Republicans have become more consistently conservative in the past few years while the Democrats have become thoroughly liberal.

The problem with this long-awaited ideological consistency in the parties is that it is coming just when the traditional liberal-conservative dichotomy is in the process of breaking down. Especially among younger voters, there is a new perspective on politics that is neither liberal nor conservative. Many of these voters were attracted to John Anderson in 1980 and to Gary Hart this year.

William Schneider of the American Enterprise Institute describes these changing circumstances this way: "Most voters are not ideologically consistent. The typical working-class voter seeks economic protection from the Democratic Party but does not trust its cultural liberalism. Middle-class suburbanites favor Reagan's fiscal conservatism but are repelled by the Moral Majoritarianism, anti-environmentalism, and foreign interventionism of the current Administration."

Michael Barone and Grant Ujifusa of *The Almanac of American Politics* estimate that by 1980 some 25 percent of the electorate could have been described as fiscally conservative and culturally liberal. Terry Nichols Clark of the National Opinion Research Center writes that "most Americans today are fiscal conservatives but social liberals."

Americans between the ages of twenty-five and forty, who lived through the era of Vietnam, Watergate, and stagflation, have learned to be skeptical of government's ability to bring about desired results. No matter how good a government's intentions, the world is a complex and delicate system that is not often receptive to manipulation. Vietnam taught young Americans that the world cannot be controlled from Washington. (If the Soviet Union had a free press, Afghanistan would today be teaching young Russians that the world cannot be controlled from Moscow, either.)

Decades of Keynesian fine-tuning of the economy and a growing welfare state led in the 1970s to increasingly severe cycles of inflation and unemployment and a rising poverty level beginning about 1978. The American economy proved no more controllable than international affairs. While these experiences illustrated the failure of even a well-intentioned government, Watergate reminded us that governments are often not well-intentioned.

As baby-boomers move into positions of leadership in the United States, we can expect these attitudes to have a powerful influence on the course of events. There will be young political and intellectual leaders of all viewpoints, of course. But a large number of young Americans will be sympathetic to a program of peace, arms control, civil liberties, tax reduction, and deregulation.

The Cato Institute is currently pursuing a number of studies that should fit well with this new approach to politics:

- Earl Ravenal's work, particularly his recent *Defining Defense* and his forthcoming *Foreign Policy in an Uncontrollable World*, points the way toward greater national security at a lower cost and with a reduced risk of nuclear confrontation.
- Peter Ferrara's proposal for privatizing retirement insurance, first presented in *Social Security: The Inherent Contradiction*, would allow for a major reduction in the size of government and should appeal especially to young workers.
- Free-market environmentalism, as discussed in many *Cato Journal* articles, in Terry Anderson's *Water Crisis: Ending the Policy Drought*, and in forthcoming works, offers a way to protect the environment without inefficient bureaucracies.

In a number of other areas as well scholars associated with the Cato Institute will be offering policy options consistent with this new emerging perspective, which might be summed up as "peace and free enterprise"—a perspective different from traditional liberalism or conservatism that offers the potential of fundamentally altering America's future. ■

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Inflationism (Cont. from p. 1)

Such an argument is remarkable for its naively Keynesian notion of how budget deficits stimulate the real economy and for its calm acceptance of inflationary debt repudiation as a revenue source. Roberts even projects this "decline in real value of public debt" several years into the future to show a "net adjusted deficit" declining as a percentage of GNP.[6] (He also counts state and local government surpluses as an offset to the federal deficit.)

Anyway, says Roberts, "if government must spend, borrowing may be a more efficient way to finance it than taxation. Taxation often falls on the most efficient users of resources and producers of goods and services, but in an efficient capital market government borrowing diverts resources from the least efficient private uses."[7]

Is the Fed Slowing Growth?

Just in case they haven't sufficiently talked deficits or their supposed significance away, Roberts and other supply-siders (notably Congressman Jack Kemp in many speeches and newspaper articles) have another string to their bow. The deficits are largely due to inadequate economic growth, for which the Federal Reserve is to blame. Its monetary tightness caused the recession of 1981–82; and after an interlude of mercy it is again courting another recession, which will again curtail tax revenues and increase government expenditures.

Actually, the Federal Reserve had no way to slow inflation without recession occurring as a side effect, and those economists of the rational-expectations school who suggested otherwise were speaking irresponsibly. With hindsight, of course, it is easy to argue that the Federal Reserve should have applied the monetary brakes more gradually and smoothly.

Of course Federal Reserve behavior provides much to criticize, and seizing that opportunity is an old academic tradition hardly confined to supply-siders. The Fed has erratically gunned and choked the money supply. It has bureaucratically dragged its feet on accepting monetarist theory, adopting monetarist policies, and adopting the operating techniques necessary to achieve smooth monetary growth. Instead of passively accepting the role of scapegoat, the Federal Reserve, with poetic justice, perhaps, has done some scapegoating and alibi-mongering of its own: Chairman Volcker has repeatedly admonished Congress and the administration on fiscal policy.

Outsiders can hardly correct its behavior, however, by badgering the Federal Reserve with contradictory and changeable advice based on casual observations, questionable economic theory, and political motives. Public discussion of economic issues in the United States does seem afflicted with an excessive focus on the short run; and with obsessions about predicting and explaining particular business recessions and recoveries and assigning blame and praise. The same is true of commentary on interest rates. By and large, participants in public discussions could use a better understanding of what it is that the interest rate is the price of, what determines that price, what little control the central bank has over those fundamental factors, and how efforts to lower interest rates in the short run are likely to boomerang later. Flexibly tailoring economic policy to the latest news and the latest whims of influential persons stands at the opposite pole from seeking a stable structure of institutions and guidelines within which workers, consumers, savers, investors, and the business community can plan for the long run with reasonable confidence.

> **"A few supply-siders are almost overtly inflationist."**

It was hardly helpful, then, when Congressman Jack Kemp, in a talk to Federal Reserve officials on 2 June 1983, noted "a need for some cyclical recovery in commodity prices that are still below cost" and called for an immediate cut in the discount rate. Similarly, declines in the price of one particular commodity, gold, have served Jude Wanniski as evidence "that Federal Reserve policy is not sufficiently easy" and "that accommodation by the Fed would not be 'inflationary.'"[8] (Wanniski's putting the word "inflationary" in quotation marks itself bespeaks his attitude.) Wanniski urged creation of enough bank reserves to move the price of gold back up to $425 and stabilize it there. He calmly accepted the prospect that, as a result, "consumer prices would rise for several years at modest rates until the general price level caught up to gold" and to other sensitive commodity prices.

Caricaturing Monetarism

Since I am commenting on several supply-siders' scorn for monetarism, I must forestall misunderstanding by explaining my own position. I doubt that fiat money managed along monetarist lines is the best arrangement for the long run. Nevertheless, I recognize that the monetarists (Milton Friedman, Karl Brunner, and Allan Meltzer, among others) have made great contributions to analyzing the causes and effects of money-supply changes under existing arrangements. I believe that their proposed quantity rule is the best guide to monetary policy *in a system of our existing type*.

Alan Reynolds (Wanniski's associate in a consulting firm) and Congressman Kemp have caricatured monetarism unfairly. According to Reynolds,

> macroeconomics attempts to predict and regulate my wife's spending habits. Now I find this difficult to do from New Jersey, but they're going to do it from Washington, D.C., and not only for my wife, but for everybody else. The attempt here is to regulate the growth of nominal GNP or total spending in the economy.
>
> There are two theories on how to go about this. One theory is that before my wife makes a spending decision she looks in her check record of a year ago and finds out that the balance was, and then makes the decision on that basis. That's called monetarism with a one-year lag.[9]

Kemp's speech of 2 June 1983 contains a similar caricature:

> According to one theory of demand management, the decision to buy a car today is based on how much money a person had in his wallet or checking account a year ago. This is called monetarism with a one-year lag. It is even supposed to work for business. If a corporate treasurer accidentally discovers an extra million

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Inflationism (Cont. from p. 3)

dollars in the company checking account, then the company will supposedly buy more inventory or hire more workers a year later.

Jude Wanniski is one of the supply-siders who have been decrying the monetarists' emphasis on the quantity of money and urging adoption of a "price rule" instead. He prefers attention to the price of gold. He warns that "a rise in money's value"—by which he means a fall in the price of gold—"is as harmful to economic growth as is a fall in value."[10] He advocates a gold standard—not, however, of the "bad" kind advocated by "men with steely eyes, thin lips and tight fists . . . [who] love it for its powers of 'discipline'," a standard whose "objective is to prevent the government from increasing the money supply too rapidly, on the grounds that such an increase must be inflationary." No, Wanniski wants a gold standard of the "good" kind, one that would stabilize money in value while allowing its quantity to satisfy the demands of the public, one that in the conditions of mid-1983 "would guide the Federal Reserve . . . towards a neutral stance, if not a policy of monetary ease."[11]

Supply-siders urging some sort of gold standard include Congressman Kemp, his friend Professor Robert Mundell, Alan Reynolds, and Lewis Lehrman (businessman, politician, and think-tank chairman).[12] Many supply-siders also want to restore something like the Bretton Woods system of fixed exchange rates. Its demise, they observe, was followed by a worldwide burst of inflation around 1973–1974. They forget that the chief source of this inflationary surge was precisely the last-ditch effort to keep the Bretton Woods system patched together: monetary authorities around the world created what turned out to be excessive amounts of local money as they strove to keep their own currencies from rising against the shaky U.S. dollar. Before wanting to repeat history, one should at least try to understand it.

> "Gilder implies that inflation somehow fostered the rapid growth of Japan, Taiwan, and Korea."

I hope the conjecture that follows is not too cynical: Advocacy of a gold standard and fixed exchange rates offers the supply-siders two tactical advantages (which is not to say that they have thought of them explicitly). First, advocating the traditional real, hard money—or something advertised under the same name—serves as a claim to antiinflationist credentials. Second, recommending a reform unlikely to be implemented any time soon provides an excuse for the failure of other parts of one's program. (Lewis Lehrman suggests, for example, that a gold standard would promote confidence, low interest rates, productive investment, healthy and rapid economic growth, and, by implication, increased tax revenues. Surely he isn't to blame if his wise advice goes unheeded.)

A few supply-siders are almost overtly inflationist. George Gilder is an example.[13] Instead of keeping the money supply tight, he says we should fight inflation by "unremitting cultivation of the supply of new goods" (*Wealth and Poverty*, p. 218). Anyway, "the money supply is an essentially mathematical concept that means less than it seems" (p. 195). An "expanding money supply merely makes it possible for private activity to continue" despite massive tax burdens (p. 205). "Monetary restrictions chiefly dampen private-sector growth and promote the very expansion of the public sector, which caused the problem in the first place" (p. 202). They "are a wonderful way to destroy the private sector while leaving government intact and offering pretexts for nationalizing industry" (p. 204). Gilder thus seems to think that monetary inflation retrieves resources for the private sector—somehow—from preemption by the public sector. He implies that inflation somehow fostered the rapid growth of Japan, Taiwan, and Korea (p. 201). Far from being an affliction, inflation in some circumstances may be a healthy adaptation to change (p. 195). Over the long run, he says, periods of inflation have been "none other than the most glorious stages of human economic history" (p. 198). Gilder's arguments thus have a mystical, poetic quality; they are not economic analysis.

The policy positions of the supply-siders suggest their belief—or hope, rather—that all desirable results fit together, that all relevant considerations point in the same direction, that the one best line of policy is clear, and that the chief obstacle is the resistance of the unenlightened. Supply-side policies, including some sort of commodity standard for money, will spur work and

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Defense Spending Debated

Earl C. Ravenal, a Cato Institute board member and author of *Defining Defense: The 1985 Military Budget*, spoke about his proposal for a noninterventionist foreign policy during a Cato Policy Forum in April. Bruce Weinrod, director of foreign policy and defense studies at the Heritage Foundation, gave a comment on Ravenal's talk.

Few critics have dared to point the finger at the fundamental element in the defense budget, according to Ravenal. Force structures, or the total system of armed divisions, aircraft carrier groups, tactical air squadrons, and so on, must be reassessed and redesigned if there is to be any hope of significantly cutting defense spending. "The point is," Ravenal said, "that you cannot cut major elements in the force structure, which in turn is necessary to make appreciable and lasting cuts in the defense budget, without also eliminating the global missons of those major elements."

"If we eliminate the missions of those forces," Ravenal said, "then we will be implicitly changing our national strategy. In turn, our foreign policy is going to have to change." He suggested that in coolly assessing the requisites of the modern battlefield, and the reality of what American troops are likely to face against "capable and determined adversaries," the choice becomes whether or not to fight against those adversaries in certain environments. What must be questioned, Ravenal said, is "our his-

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Industrial Policy Examined at Conference

The question of whether the United States needs an industrial policy to improve productivity and strengthen its competitive position in world trade was addressed at a two-day Cato conference held last April in Washington. "Planning America: Government or the Market?" brought together more than two dozen experts in politics, economics, and management to discuss what is certain to be one of the major policy controversies of the decade.

Representative John J. LaFalce (D-N.Y.), author of two bills pending in Congress that would implement a form of industrial policy, opened the conference with a call for government-business-labor cooperation in solving America's economic problems. He said the issue is not government versus the market, but rather how to draw on the strengths of both. Venture capitalist Don L. Gevirtz, author of *Business Plan for America*, discussed the importance of the entrepreneur in creating jobs and economic growth. Federal Trade Commission executive director T. Bruce Yandle, filling in for ailing FTC chairman James C. Miller III, gave a hard-hitting critique of industrial policy proposals and defended the marketplace as the most efficient mechanism for allocating resources.

William A. Niskanen, a member of the President's Council of Economic Advisers, said in a luncheon talk that the choice is a clear-cut one between two policies: using government to promote solutions, or rejecting any government role as unavoidably disruptive and inefficient.

John W. Kendrick, a professor of economics at George Washington University, said "a federal government productivity organization is unnecessary, and . . . a formal apparatus to design and execute 'industrial policy' would reduce, rather than enhance, the growth of overall productivity and economic welfare." The basic point, Ken-

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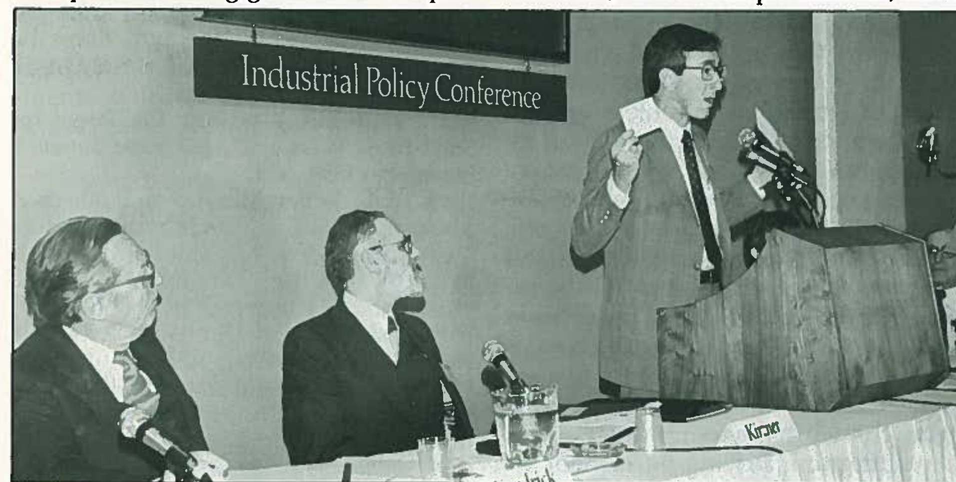
drick said, "is that we are not omniscient enough to pursue a systematic, centralized industrial policy that would be effective in the sense of giving better results than the market in our complex and dynamic type of economy. The important role of government is to provide a reasonably stable, favorable environment for private enterprise."

John M. Albertine, president of the American Business Conference and a former executive director of the Joint Economic Committee, suggested that American productivity is lower than that of Japan because capital is more expensive and thus in shorter supply, and because it has often been invested in inefficient, declining industries. But to Albertine, the main culprit is the corporate income tax, which he called a "perversion." The corporate tax, Albertine said, "is a tax on production, and it causes non-optimal allocations of our scarce resources. It may be the biggest barrier to economic growth in our country . . . I think that, sooner or later, the corporate income tax should be abolished." Albertine concluded: "If the government had begun picking winners when interventionist industrial policies were first discussed, my kids would probably be playing with hula hoops, instead of computers."



Alvin Rabushka of the Hoover Institution speaks at industrial policy conference as John Kendrick of George Washington University and Israel Kirzner of New York University listen.

One way economists have tried to empirically test the application of industrial policies has been to study the economies of the Eastern European countries, especially Hungary and Yugoslavia, where some features of capitalism have been incorporated into centrally-planned, socialist systems. In "Industral Policy in Hungary: Lessons for America," Arizona State University economics professor Josef C. Brada closely examined Hungary's extensive industrial policy and concluded that the results, in terms of efficiency, were mixed at best. Brada said that his survey of the Hungarian economy indicates "that one of the more difficult aspects of formulating policy has been the selection of sectors to be promoted. This has been largely due to the inability to predict whether or not enterprises can, in fact, develop comparative advantages in the production of new products." Brada predicted that similar targeting difficulties would also arise in market economies, because "such a policy may prove so unfocussed that none of the recipients of government support would receive enough resources to produce an appreciable result."

Also participating in the conference were Paul Craig Roberts, Israel Kirzner, Amitai Etzioni, William G. Ouchi, Leland Yeager, Harold Demsetz, Don Lavoie, Mario Rizzo, and several other economists and policy analysts. Among the media were reporters from the *Wall Street Journal*, *Newsday*, the Associated Press, *Harpers*, *Business Week*, *U.S. News & World Report*, and the *Washington Times*.

Most of the papers and comments delivered at the conference will be published in the Fall 1984 *Cato Journal*. ■

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investment, reduce interest rates, and bring healthy and sustainable growth. The federal deficit in turn will disappear, or at least is not very serious. It does not bid up interest rates; it does not crowd out private investment (or at least not more than extra taxation would); it does not promote inflation. Or if the deficit does tend toward inflation, other strands of policy can hold that result in check; and besides, inflation itself may not be so harmful. If things go wrong nevertheless, the Federal Reserve must take the blame.

In unfortunate reality, all good things do not always hang together and all considerations do not always point in the same direction. Perplexing dilemmas can arise; painful choices sometimes must be made.

The Deficit Problem

Now is one of those times. We must take the federal deficit seriously. It is irresponsible to insist on the lack of clear evidence that it does damage in the short run and to hope that it will somehow disappear in the longer run. Every annual deficit locks the government into still bigger recurring interest payments on a growing national debt. Already, as a matter of arithmetic, interest payments alone account for more than half the deficit.

Suppose that the deficit (in billions of dollars) is 200 in year 0, adding 200 to the existing debt, and that the interest rate is 10 percent. With other influences on it unchanged, growing interest payments alone would nearly double the deficit, to 390, by the end of year 7. The cumulative additional debt would then amount to 2287. By the end of year 15 the annual deficit would amount to 835 and the cumulative additional debt to 7190. These calculations of compound interest at work are only illustrative, of course. The reader should try substituting his own interest rate and other numbers; the calculations will still be sobering.

Even before taking an allowance for expected inflation into account, one can hardly believe that private investors would go on absorbing and holding government debt amounting to ever-larger shares of their total portfolios at an unchanged interest rate. Surely the rate would have to rise, thereby intensifying the mechanical upward interaction of deficits and debt.

Pressure on the government (including the Federal Reserve) would grow ever more intense to lighten the debt burden by partial repudiation. The repudiation would be indirect, of course—disguised by inflation. (Already, as we have seen, Paul Craig Roberts tacitly counts on such repudiation to continue in the future as in the past.) It is grossly irresponsible, therefore, to preach complacency on the grounds that the historical record shows no unmistakable, mechanical influence of deficits on inflation—or interest rates—in the short run.

> **"Today's tacit alliance between big spenders and supply-side inflationists could result in the ultimate destruction of the dollar."**

The time has come for drastic government spending cuts even of kinds that might have seemed politically out of the question earlier. Yet supply-siders of the Arthur Laffer wing, in particular, have been ignoring or even denying this necessity.

The process whereby deficits expand themselves through interest payments on an ever-growing government debt makes the budgetary problem urgent. The dangers of delay have made me ponder the idea of strictly temporary tax increases framed to minimize disincentive effects and enacted as part of a package that brought agreement on permanent spending cuts. Unfortunately, tax increases would more likely encourage than restrain the big spenders. Furthermore, as President Reagan used to say, the nearest thing to eternal life on this earth is a temporary government program. Buying agreement on spending cuts with strictly temporary tax increases that staunched the deficit while those cuts took effect presupposes reform—already achieved somehow—of the political system that has been creating our present difficulties over many decades.

The idea boils down to the not very helpful recommendation that we somehow quickly correct the perverse political incentives lying at the roots of our budgetary problem. I cannot be very hopeful. If today's tacit alliance between big spenders and supply-side inflationists should cause delay and should result in the ultimate destruction of the dollar, we who are more libertarian and more responsible should at least be prepared to draw the appropriate lessons. And we should be ready with ideas for constitutional and monetary reform. ■

[1] Hobart Rowen, "Feldstein: A Hard Act to Follow," *Washington Post*, 13 May 1984, p. G1.
[2] See Roberts's *Business Week* columns "Why the Deficit Hysteria is Unjustified," 5 December 1983, p. 12, and "The Fed Is Jeopardizing Recovery," 6 February 1984, p. 11. See also his other *Business Week* columns, his columns in and letters to the *Wall Street Journal*, and his *The Supply-Side Revolution* (Cambridge: Harvard University Press, 1984).
[3] Roberts, "Why the Deficit Hysteria Is Unjustified."
[4] Ibid.; also Roberts, "Supply Siders Had It Right the First Time," *Business Week*, 9 January 1984, p. 12, and "Hard Evidence That Dispels Myths About the Deficit," *Business Week*, 21 May 1984, p. 22.
[5] Robert Eisner and Paul J. Pieper, "A New View of the Federal Debt and Budget Deficits," *American Economic Review* 74 (March 1984):11–29.
[6] Roberts, "Supply Siders Had It Right the First Time."
[7] Roberts, "Mr. Feldstein's Fiscal Folly," *Wall Street Journal*, 1 June 1983, p. 30.
[8] Jude Wanniski, "The Fed: On Target for Snail-Paced Recovery," *Wall Street Journal*, 9 November 1983, p. 30.
[9] Jack Kemp, Robert Mundell, and others, *A Monetary Agenda for World Growth* (Boston: Quantum, 1983), p. 124. This book contains the proceedings of Kemp's "pre-Williamsburg" conference of May 1983.
[10] Wanniski, "Supply-Side Wins," *New York Times*, 25 March 1983, p. A31.
[11] Wanniski, "The Gold Standard: the 'good' and 'bad' kind," *The Washington Times*, 28 June 1983, p. C1.
[12] See *A Monetary Agenda for World Growth*.
[13] See George Gilder, *Wealth and Poverty* (New York: Basic Books, 1981).

Cable Freedom, Tax Cuts Backed by Cato Authors

Defining Defense: The 1985 Military Budget, by Earl C. Ravenal, published in April by the Cato Institute, is being touted in the press as offering one of the few real alternatives to President Reagan's military buildup. *The Washington Post*, the *New York Times*, and the *Christian Science Monitor* all mentioned Ravenal's proposal to freeze spending and cut forces as being among the two or three serious alternatives to Reagan's budget.

Post columnist Stephen Rosenfeld called Ravenal "a relentless logician," and said that the Georgetown University professor is almost alone in being willing to accept the challenge of eliminating many of the country's commitments overseas. Rosenfeld concluded: "If these issues are not addressed forthrightly, the debate could yet start turning, with Ravenal, to questions of purpose."

The Ravenal study was also extensively quoted in Stephen Chapman's syndicated column, which appeared in the *Chicago Tribune*, *St. Louis Post-Dispatch*, and other papers as well as in magazine articles.

* * * * *

Underground Government: The Off-Budget Public Sector, by George Mason University professors Thomas DiLorenzo and James Bennett, was reviewed at length in the May issue of *Reason* magazine. Yale University economist Jennifer Roback called the book "well worth reading," and said that Bennett and DiLorenzo "make a persuasive case that consitutional amendments will not inhibit the growth of government spending."

* * * * *

Freedom, Feminism and the State: An Overview of Individualist Feminism, edited by Wendy McElroy, received a favorable review in the June issue of the *Humanist*. Writer Pat Shockley said the book "is for the person who wishes to question and to rethink basic values, be they feminist or socialist, and who wishes to know more. Surely that is the humanist tradition."

* * * * *

Jennifer Roback's article on taxation and government spending, timed for release around the April 15 tax return deadline, appeared in the *Philadelphia Inquirer*, the *San Francisco Chronicle*, the *Chicago Tribune*, and the *St. Louis Post-Dispatch*. Roback asserted that "there can be no tax relief until the government reduces its spending." She went on to explain how the government raises money through either overt taxation or deficit financing, the latter method involving both borrowing money and printing it. Roback concluded that public opinion strongly favors lower taxes and reduced spending, but that so far no one has had the political will to cut programs.

* * * * *

Michael Babcock, author of a recent Cato Policy Analysis on railroad deregulation, wrote an op-ed on the same subject that appeared in the *St. Louis Post-Dispatch* and the *Indianapolis Star*. Babcock criticized current industrial policy proposals by relating how government management in the railroad industry has failed over the years. Government policy, Babcock wrote, tended to encourage alternative modes of transportation, and to hobble the railroad industry by restricting operators' freedom to adjust to market conditions. "The experience of the U.S. rail industry," Babcock wrote, "indicates that the problems of ailing industries are not likely to be solved by government intervention."

* * * * *

Clint Bolick, a lawyer at the Mountain States Legal Foundation in Denver, published a long column in the Sunday *Washington Post* opinion section based on his recent Policy Analysis study of cable TV. In "Cable TV: It's Prime Time for Competition," Bolick analyzed the First Amendment implications of allowing cities to decide who may have a monopoly on cable service. The myth of natural monopoly, which lies at the heart of most arguments for municipal regulation, is obsolete because of changes in technological efficiency, according to Bolick.

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Lawyer Michael McMenamin's column about the politics of agricultural marketing orders appeared in, among others, the *Cleveland Plain Dealer*, the *Des Moines Sunday Register*, the *St. Louis Post-Dispatch*, and the *Indianapolis Star*. In his article, McMenamin examined the wastefulness and excessive costs brought about by agricultural marketing orders, which regulate the production and marketing of agricultural commodities, and chided the Reagan administration for ignoring its own alleged free-market principles by doing nothing to eliminate the program.

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Cato president Ed Crane's lengthy *Inquiry* article examining the life and politics of Chrysler president Lee Iacocca was excerpted in the Baltimore *Sun* and mentioned in the *Detroit Free Press*. Crane detailed the story of Iacocca's rise to the top of corporate America, the Chrysler bail-out, and Iacocca's ongoing attempts to influence the industrial policy debate. "That command economies—complete with five-year plans—are the subject of near-universal ridicule seems to escape Mr. Iacocca as he searches for ways to remove all uncertainty from Chrysler's future," Crane wrote.

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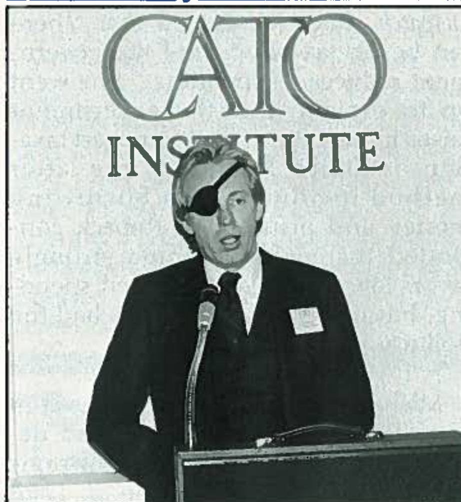
Lindley H. Clark, Jr., the dean of economic writers at *The Wall Street Journal*, based one of his columns on the Cato conference, "Planning America: Government or the Market?" which was held in April. Clark referred extensively to a paper given by John W. Kendrick, a George Washington University professor, and said that, in Kendrick's view, the primary role for government "is to provide a reasonably stable, favorable environment for private enterprise. He didn't oppose some role for government in smoothing the effects of economic change, but some conference attendees weren't willing to go that far." Referring to a speaker who proposed a council of industrial advisers, Cark wrote, "He wasn't exactly hooted down, but neither did he draw much support. There also was little support for the notion of a closer partnership between business and government. Partnerships require mutual trust and, at least on one side, there isn't much of that."

Slowing Federal Spending: A Budget Alternative

Every month the Cato Institute sponsors a Policy Forum at its Washington headquarters where distinguished analysts discuss their views with an audience drawn from government, the public policy community, and the media. A recent forum featured Richard Rahn, vice president and chief economist of the Chamber of Commerce, and Ronald D. Utt, the Chamber's deputy chief economist, discussing the Chamber's federal budget proposal. Commenting on their remarks was J. Gregory Ballentine, associate director for economic policy of the Office of Management and Budget.

Richard Rahn: In February 1981 the administration came out with their economic game plan, which a number of us had worked hard on during the election period. It called for getting taxing and spending by 1984 down to 19.6 percent of the GNP. That has been achieved with taxing, but not with spending. We at the Chamber have stuck with the 19.6 percent figure. In fact, we felt we were reasonable in our compromise; before the administration came up with 19.6 percent, we were at 18 percent. Those of you who suffer through *The Washington Post* each day know that they are very concerned about the deficit—which is something that has happened only since Ronald Reagan took office. But we do indeed have a problem. If we did nothing, eventually the growth in interest payments would begin to spiral out of control. We have three options. We can reduce the growth rate of government spending, we can increase borrowing, or we can increase taxes. Now what do we know as economists? We know that if we reduce the growth rate of government spending, this is unambiguously desirable if our economic goal is to increase the economic well-being of all our citizens. We also know that major tax increases are destructive to economic growth. That again is an unambiguous statement. They discourage work, saving, and investment. They reduce the freedom of our citizens to enjoy the fruits of their labor. They penalize people for engaging in productive economic activity. The administration or members of Congress never talk

Policy Forum



Richard Rahn: "We have been concerned with the 'breach of faith' on the part of Congress and the administration to come up with responsible budgets."

about that.

Now when it comes to deficits, there is a great deal of debate in the profession. The Treasury Department has done a study which demonstrates that there is no necessary relationship between budget deficits and interest rates. Usually people say they're against budget deficits because they drive up interest rates. Clearly, large deficits are bad over time because we have the spiralling interest-rate effect, and there are the various crowding out problems. If Congress and the administration really cared about all citizens, there would be only one choice and that would be to reduce the growth rate of spending. But that's not how political decisions are made. People who have a vested interest in spending lobby very effectively for those programs.

We at the Chamber have been concerned with what we consider this "breach of faith" on the part of Congress and the administration to come up with responsible budgets. Beginning last year, rather than just complain, we started offering alternative budgets. We have our own computers to replicate the work of the Office of Management and Budget. We had developed a seven-point plan with Senator Orrin Hatch and Representative Phil Gramm last year that could lead us to a balanced budget by the end of the decade under our economic assumptions, and which would not gut any existing program. We tried to be "responsible" and reasonable, and the result of our efforts last spring was to get twenty-three votes in the Senate for our bill. But we were able to shift the debate to the right, and Senator Domenici was unable to get his budget passed until he compromised with a number of our friends up there. This year we are entering the battle even more seriously, and while we do not expect to win we expect to keep up the effort. Hopefully, with a new Congress next year we can be even more effective.

Ron Utt: Before I talk about the seven points explicitly, let me mention the objectives we set for ourselves before we developed our specific proposal. First, we did not want to be oblivious to the political constraints under which we operate, and we wanted a budget that we could sell to as many people as possible. So we tried to make it as tough as possible and yet still appear to be fair and operationally feasible. A very attractive budget that was fashionable last year but lacked these considerations was the absolute freeze proposal. That plan indicated that the deficit could fall to zero within about two-and-one-half years. That works out arithmetically, but it's very difficult to sell.

Second, our plan had to address those areas of the budget that were responsible for most of the growth over the last couple of years—namely, defense, Social Security, and Medicare.

Third, it had to be simple and understandable. The public sense of the budget is that it is a complex, intractable problem that they can't even begin to understand. We wanted to demonstrate that a few simple, easy-to-understand steps could lead to very substantial savings over a fairly short period of time. You can't sell a complex 90-page document to your constituency—and we are talking about mobilizing a constituency.

Fourth, it must address the deficit in a dramatic fashion. You are not going to mobilize a constituency around a plan that reduces the deficit by $10 billion a year.

With these four objectives in mind, we came up with our seven-point plan. Our first major effort is against the automatic cost-of-living adjustments (COLAs). About one-third of the federal budget is indexed automatically to 100 percent of the increase in the cost-of-living index. That provision is very expensive. It gives Congress virtually no control over spending patterns. The notion is going around now that because inflation is down, COLAs no longer present a problem. In fact, by 1989, spending on Social Security alone will be $40 billion higher as a result of COLAs alone.

We built the following proposal. First of all, we propose a one-year freeze on COLAs to offset the overindexing of the past. It is our estimate that the 1978 to 1981 overindexing of COLAs accounted for an additional $14 billion, which would be about one-third offset by our freeze. Then we propose that from 1986 to 1989 indexing would be reduced from 100 percent to 60 percent. We found that in most private sector collective bargaining agreements where an automatic COLA exists, it averages between 50 and 70 percent. So we are providing no more to government beneficiaries than to taxpayers. Applied to the president's budget and economic assumptions, this proposal would save about $20 billion a year by 1989.

Our second proposal, in an area that's difficult for the Chamber to get into because of the prodefense constituency that we represent, reduces the defense budget. Here we decided simply to go back to the president's original proposal in 1981 that defense growth should be held to 7 percent per year in real terms. We have applied that to the existing Reagan budget. Because the defense budget is front-end loaded, the savings here will largely occur in the earlier years. We estimate that this would save $7 billion in 1985, and $14 billion in 1986.

The third area we focus on is Medicare. Medicare is probably one of the most emotional parts of the budget to deal with. We have no easy solution to this, so we set an objective of finding a fair and salable proposal. We recommended that Medicare benefits should be held constant on a real per capita basis. Thus, Medicare expenditures over the next five years should grow no more than the GNP deflator plus the increase in the number of new beneficiaries who would be entitled to the program. Our estimate is that this approach would produce savings in 1989 of about $21 billion. Recently when I presented this plan to fiscally conservative Senate aides, they called it the "scorched earth budget." So we give you some options at this point. If the Medicare proposal is too tough, we can move some money around and still achieve essentially the same results. If you reduce defense spending from 7 percent real growth to 6 percent real growth a year, and allow Medicare ben-

Norman B. Ture of the Institute for Research on the Economics of Taxation asks a question at Policy Forum.

efits to grow by 2 percent, you can still save a substantial amount of money.

A fourth proposal concerns federal pay. We go back to the president's proposal last year for a one-year freeze, followed by a 3.5 percent increase for the remaining year. This doesn't mean we freeze or eliminate raises for individual workers. We are talking about the total federal payroll. Individual federal workers would still be eligible for a competitive increase if more attrition is allowed in the work force. It would not be necessary to lay anyone off.

Fifth, in all the discretionary accounts, we simply accept what the president has proposed. In agriculture, we accept his freeze, we accept his changes in Medicaid, food stamps, and so on. At this point we simply have not had the time and resources to get into all these individual programs.

Number six addresses the revenue side. We propose here that all government workers and the remaining nonprofit employees be brought into the Social Security system. Now, this has raised a number of objections on different ends of the spectrum. On the one hand, civil servants say it would be unfair to alter implied contractual arrangements that we already have with them. On the other hand, from the libertarian point of view, how can we propose expanding a system that we don't support anyway? These are all good points, but the fact remains that, according to a recent GAO study, 81 percent of the retired federal workers are eligible for Social Security anyway. If they are going to be receiving the benefits, they ought to be paying the taxes.

Our seventh point, which really doesn't affect the unified budget deficit that we've been focusing on, is that now is the time to start making an effort to clean up the off-budget programs, which are largely loans and loan guarantees. For starters, we propose that these spending proposals be brought into the federal budget process. Some of the Federal Financing Bank activity might be put on budget. Finally we ought to address some of the subsidized loans with rates as low as 5 percent to various industries and interest groups.

That is basically our proposal now. As we cost it out, we end up with a unified budget deficit in 1989 of about $45 billion. If we do that switch on Medicare and defense, the 1989 deficit falls to about $35 billion.

Greg Ballentine: There is less fundamental difference between the Chamber's position and the administration's proposal than you might think. However, there are some important differences in timing, and in the perception of what is politically acceptable. As one example, a major part of the Chamber's savings comes from Social Security COLA cuts. I have to ask what would be served today by the admin-

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Federal Spending (Cont. from p. 9)

istration's coming out with a proposal that is dramatically greater in its impact on Social Security outlays than the one that we initially came up with and was rejected by the Senate 76-0 in 1981. I would not underestimate the difference in our perceptions of the difficulty with proposals like that.

There also seems to be a difference in emphasis, if not in fundamentals, from some of Richard Rahn's comments on the means of financing the government. The administration remains committed to a balanced budget once an acceptable spending program is in place. That is partially due to political considerations, but also based on the view that financing the government through taxes is more efficient over the long term. With the level of spending we would approve, we would not choose to continue financing the government by means of borrowing.

To get to my main points, I think ours is a practical budget. It does not do a great deal with respect to spending today. It announces a commitment to do more in the future. We perceive an enormous difficulty in achieving the spending cuts we need in today's political framework. We need to build a consensus. That consensus is only going to come about as we get groups like this, the Heritage Foundation and others, to discuss details of the budget.

Another point is the importance of getting beyond statements about goals, like reducing spending as a fraction of GNP to 19 percent. That's not a budget. A budget is a program that has specific proposals for specific activities and says how we're going to limit them. To build the kind of consensus we need it is not adequate to say "freeze this" or "keep this down to the same rate of GNP in 1965." Instead, we need discussions like this that look at specific proposals. This is necessary in order to remove the correctly perceived difficulty in taking dramatic steps today.

I looked at four of the seven components of the Chamber's budget in detail. In costing out these four proposals, I did not get the magnitude of numbers that Ron Utt did, but he did have other proposals as well. I came up with a savings of about $70 billion in 1989 from a current services deficit in 1989 of about $207 billion. I still end up with a deficit of about $140 billion. Most of the savings are in Social Security and Medicare. No savings are from defense by 1989. There are savings of about $27 billion in Social Security and another $10 billion in other COLA programs, about $37 billion in the health programs, and small savings in the employee payroll—a total of around $70-75 billion.

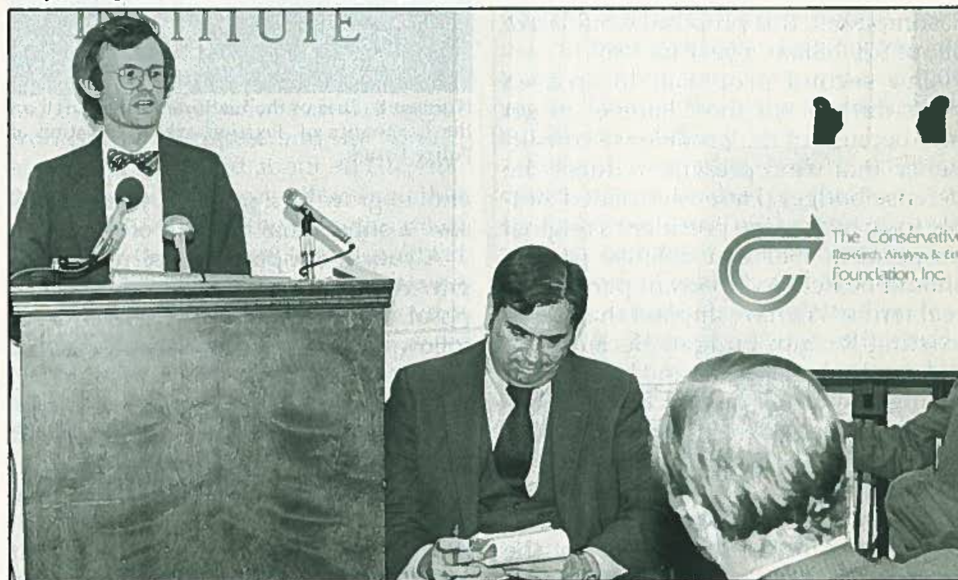
Finally, I would contrast this plan with the Heritage Foundation proposal that is much more detailed. One point it made is that whatever our views about a general increase in revenues, it is not appropriate to leave aside the tax side entirely. The Heritage plan examined, for example, the administration proposal to limit tax-exempt employer contributions for health insurance, taxing of unemployment benefits, and removing the elderly tax credit. Energy tax credits should be examined on that side just as you look at energy loan programs. We should not ignore the various proposals on the revenue side.

Richard Rahn: Ronald Reagan was elected on a platform of bringing down government spending. The candidate had a rather precise definition of the level. I believe it is incumbent upon the administration to at least send to Congress a budget that approaches the growth rate reduction upon which the president ran. Of course, the Congress may not pass it. Some of the programs may be hard to achieve.

But you can set goals and objectives. Let's take Medicare. This past year, I served on the Social Security Advisory Council dealing with Medicare. If you want to hit the budget targets we put in there, one way to do it right off is to begin to increase the deductible amount. You can increase the deductible up to any level. You would be moving toward catastrophic insurance here. What the elderly really fear is not being able to pay the big bill. You know, the after-tax family income of retired Americans is now slightly higher than the average after-tax income for working Americans. I am a great skeptic of redistribution programs in general. But income redistribution programs that take from the young poor to support the old rich, I really have problems with.

The administration has not done the selling job it could have with the kinds of statistics available to it. We have a president who is referred to as a great communicator, but he has not gotten up there and educated the American people.

There is a golden opportunity which may have been missed for the last two years. But I hope the new administration (hopefully the president will be reelected) will become bold again and go after some of these fundamental changes we need to rectify the problems. ■



The Conservative Caucus held a media briefing on the flat-rate tax, featuring Rep. Mark Siljander (R-Mich.) and several economists, at the Cato Institute. Here Stuart Butler of the Heritage Foundation speaks as Caucus Chairman Howard Phillips checks his notes.

Brownstein Testifies on Price-Anderson, Whatley Condemns Government Censorship

The Price-Anderson Act, which sharply limits the liability of nuclear power plants in the event of an accident, is an inappropriate subsidy that misallocates energy resources, according to a recent Cato study titled "The Price Anderson Act: Is It Consistent with a Sound Energy Policy?" by Barry P. Brownstein, director of the Bureau of Business Research at the University of Baltimore.

Brownstein writes, "Whether the nuclear industry survives is best left to the free market to decide. Only a full repeal of the Price-Anderson Act will allow for the internalization of all costs. . . . The public is best protected by a free-market energy policy that guarantees that each resource is placed in its highest-valued use."

On the basis of this study, Brownstein was invited to testify at an oversight hearing conducted by the House Subcommittee on Energy and the Environment chaired by Rep. Morris K. Udall. The current extension of the Act does not expire until August 1, 1987.

In another recent Policy Analysis Frederick W. Whatley, an attorney specializing in national security and censorship law, condemned recent actions by the Reagan administration designed to plug security leaks by imposing censorship oaths and other restrictions on government employees.

In 1983 the Reagan administration issued National Security Decision Directive 84 (NSDD 84). This directive, which would apply to all executive branch agencies, would make a lifetime censorship oath mandatory for all government employees who have access to sensitive information.

Whatley condemns the concept of prior restraint embodied in the government's nondisclosure agreements, and argues that they have no place in a free society. The ultimate effect of NSDD 84, Whatley argues, would be to stanch the flow "of information leaked to the media by conscientious government employees concerning cost overruns, embarrassing blunders by officials, and outright 'official' lies."

Deborah Walker, a research fellow at George Mason University's Center for the Study of Market Processes, analyzes the growing public policy issue of "comparable worth" in another recent study. The paper, "Value and Opportunity: The Issue of Comparable Pay for Comparable Worth," concluded, among other things, that comparable worth legislation would cause "severe shortages in some occupations and an excess supply in others."

The proponents of comparable worth legislation assume that particular jobs have intrinsic value or worth, and that existing wage differentials between different occupations result primarily from sex discrimination. Walker attacks both these notions. "Only individual consumers," she writes, "can compare the worth of a job with the worth of any other job. . . . Through their actions in the market, consumers signal employers as to which employees they value highest. These employees will rightfully command higher wages." ■

Defense Spending (Cont. from p. 4)

toric effort to defend half the world against the other half."

Weinrod sharply disagreed with Ravenal's framing of the priorities, although he did agree that those who would drastically cut defense spending must be specific about those forces they would be willing to do without. He said there were arguments in favor of the Ravenal proposal but made it clear that he feels national security outweighs them all.

Weinrod disagreed with Ravenal's assertion that the majority of Americans accept the need to cut defense spending, saying that according to polls most people prefer some sort of increase. He dismissed fears that the economy cannot sustain such high spending, citing the fact that defense spending as a percentage of Gross National Product was much higher during parts of World War II and the Vietnam War. "I would argue that we could increase it substantially and *not* harm our economy," Weinrod said.

The best way to evaluate the nation's defense needs is to judge its foreign policy needs, not the other way around, according to Weinrod. An honest assessment of the nature of the Soviet threat, he said, must be part of the analysis. Accusing Ravenal of what he called "Kissingerian pessimism, which seeks to adjust, accommodate, and accept, rather than change" public opinion or other factors imposing constraints on defense increases, Weinrod defended the role of the government in responding to a perceived threat by mobilizing political sentiment in support of the necessary redirection of resources.

Ravenal responded with the specifics of his proposal, including freezing the defense budget at the 1985 level of $271 billion for ten years, which he said would save $3 trillion out of the $5 trillion that would have been spent during that period under the Reagan proposal. Ravenal said he would reduce the number of troop divisions on land from twenty to eight, stationing all of them on U.S. soil; shed our commitments to Western Europe, Japan, and the Persian Gulf; and cut about one-third of the nuclear forces. The extended U.S. commitments of the past forty years have finally "come home to roost," he said, in a way that demands "a very sharp and radical change of attitude toward . . . the larger problem of the situation of the United States in the world. And we have to look at it as a combined fiscal, social, and foreign policy problem."

The Ravenal/Weinrod Policy Forum was attended by some forty policy analysts and journalists, among them Rear Adm. Gene R. LaRocque, director of the Center for Defense Information, philanthropist Stewart Mott, Wendy Silverman of Physicians for Social Responsibility, Ted Crackel and Bob Huberty of the Heritage Foundation, Allan Frank of *Forbes*, and Peter Bernstein of *Fortune*. ■

Ravenal in *Harper's*, Epstein to Court?

Richard A. Epstein, professor of law at the University of Chicago and editor of the *Journal of Legal Studies*, has two important articles forthcoming. In "The Revitalization of the Contract Clause" in the *University of Chicago Law Review*, Epstein argues that the Constitution affords extensive protection against government encroachment on private contracts. In "Legal and Insurance Dynamics of Mass Tort Litigation" in *JLS* he considers the problems of toxic torts.

Epstein was recently mentioned in the Heritage Foundation's *Policy Review* as a possible Supreme Court appointee. Richard Vigilante cited him as one of four outstanding candidates, calling him "a brilliant young legal philosopher who would bring to the Court constitutional arguments for overruling many liberal restrictions on economic freedom."

Earl C. Ravenal, professor of international relations at the Georgetown University School of Foreign Service, has a heavy publishing schedule this summer and fall. His anthology of essays, *Foreign Policy in an Uncontrollable World*, will be published by Cato this fall. In addition, his books *NATO's Unremarked Demise* (University of California) and *Never Again: Learning from America's Foreign Policy Failures* (Temple University Press) will both be reprinted later this year.

Ravenal was a participant in a Lehrman Institute/*Harper's* symposium on "Should the U.S. Defend Europe?" which appeared in the April *Harper's*. Other participants included Irving Kristol, Jerry Brown, Robert Bartley, and Robert W. Tucker. Ravenal has also contributed articles recently to *The New York Times* and the *Los Angeles Times*, and has spoken before the U.S. Army War College, the Women's National Democratic Club, and the Woodrow Wilson International Center for Scholars.

M. L. Greenhut of Texas A&M University currently has three books on economic theory in progress. He also recently completed a study on the flat-rate tax for the National Center for Policy Analysis.

Roger L. Garrison of Auburn University has contributed a chapter on capital theory to *The Economics of Time and Ignorance* (Basil Blackwell Publishers) by Gerald P. O'Driscoll, Jr., and Mario J. Rizzo, also Cato adjunct scholars. Garrison has a number of impor-

(Cont. on p. 13)

Lawrence H. White (left) of New York University talks with Federal Reserve Board Governor Emmett Rice and Cato Vice President David Boaz at a reception in honor of his new book, *Free Banking in Britain* (Cambridge University Press).

Journal Examines Free Trade

The Winter 1983/84 *Cato Journal*, featuring papers and comments given at a conference on international trade sponsored by the Institute last September, is now available.

Subtitled "Markets, Protectionism, and the Future of Trade," the *Journal* contains articles by Charles P. Kindleberger, Leland B. Yeager and David G. Tuerck, Melvyn Krauss, Victor A. Canto, Paul Heyne, Thomas D. Willett and Mehrdad Jalalighajar, J. Michael Finger, Steve H. Hanke, and Murray L. Weidenbaum. Comments on some of these papers are offered by Edward Tower, Ronald A. Krieger, Sidney L. Jones, Earl C. Ravenal, Subroto Roy, and Gary Hufbauer.

Heyne, a professor at the University of Washington whose paper was later mentioned in the *Wall Street Journal*, offers a critique of the concept of "trade deficit," and argues that the poorly defined term is subject to political manipulation. Heyne concludes that the trade-deficit concept "ought to be abandoned, so that the way can be cleared for more responsible and effective discussion of the issues that concern us."

Murray Weidenbaum, former head of President Reagan's Council of Economic Advisers and currently director of the Center for the Study of American Business, asserts that "despite the lip service so often paid to the virtues of free trade, there is great danger that the United States is taking the lead in the current rush toward protectionism." In his paper, "The High Cost of Protectionism," Weidenbaum describes the many protectionist laws currently enforced by states and the federal government, analyzes the political pressures in favor of protectionism, and offers a five-point alternative plan of his own.

Copies of the *Cato Journal* are available from the Institute for $5.00. The annual subscription rate is $15.00 for three issues. Two- and three-year subscriptions are $30 and $45.

tant journal articles scheduled for publication in *History of Political Economy, Economic Inquiry, Journal of Macroeconomics*, and *American Economic Review*. He is also presenting papers at meetings of the Southern, Eastern, and Atlantic Economic Associations.

Thomas J. DiLorenzo of George Mason University was recently awarded second prize in the Mont Pelerin Society essay contest for his paper "The Political Economy of Industrial Policy," which he will present at the Society's international meeting in September. He has articles forthcoming in *Journal of Labor Research, International Review of Law and Economics*, and *Journal of Public Finance and Public Choice*, and has recently published papers in *Public Choice, American Economic Review*, and *Southern Economic Journal*. He is also a contributor to two books: *Neoclassical Political Economy* (Lexington) and *Taxation and Capital Formation* (Pacific Institute).

Richard H. Fink, director of the Center for the Study of Market Processes at George Mason University, presented papers recently at the Eastern Economic Association and the Western Economic Association. He has recently been named president of the Washington-based Council for a Competitive Economy.

Charles W. Baird of California State University-Hayward has a new book out, *Opportunity or Privilege: Labor Legislation in America*, published by the Social Philosophy and Policy Center of Bowling Green State University. He has an article in the Spring 1984 *Government Union Review* and will present a discussion paper at the Mont Pelerin Society meeting.

Thomas Szasz of the Upstate Medical Center in Syracuse has published *The Therapeutic State* (Prometheus Books), a collection of his writings on such provocative topics as mental health, the insanity defense, Soviet psychiatry, sex education, and drug prohibition.

James M. Buchanan, director of the Center for Study of Public Choice at George Mason Univeristy, was recently awarded an honorary doctorate at the University of Zurich and in September will receive the Frank R. Seidman Distinguished Award in Political Economy.

Vernon L. Smith of the University of Arizona is studying alternatives to the

(Cont. on p. 15)

Law Conference Planned

The Cato Institute will sponsor a conference on "Economic Liberties and the Judiciary" in Washington on Friday, October 26. The focus of the discussion will be the foundations of judicial decision making and the interrelationships among law, justice, and economics.

In addition to exploring the philosophical justifications for judicial action, participants will examine the function of property rights, how court decisions are affected by information costs, and the prevailing ideas about justice. Speakers will look at specific areas of law and public policy including antitrust, toxic torts, and insider trading.

Confirmed speakers include Henry Manne (Law and Economics Center, Emory University), James C. Miller III (Federal Trade Commission), Simon Rottenberg (University of Massachusetts), Robert Tollison (Center for Study of Public Choice), Richard Epstein (University of Chicago), Roger Pilon (U.S. Office of Personnel Management), Kenneth Elzinga (University of Virginia), Mario Rizzo (New York University), and Dom Armentano (University of Hartford).

The conference will be directed by James A. Dorn, editor of the *Cato Journal*. Additional information is available from the Cato Institute.

Is Reagan Deregulating?

President Reagan's chief regulatory adviser at the Office of Management and Budget defended the administration's record on deregulation at a recent Cato Policy Forum, but warned that advocates of "social" regulation may yet nullify much of the progress that has been made in rolling back government intervention in the economy.

Christopher C. DeMuth, head of the Office of Information and Regulatory Affairs at OMB, said "simple formulations such as 'clean air' and 'women's equity' have broad general appeal and can provide cover for the state to do what it does best—regimenting the economy at the behest of politically effective groups." In spite of this, DeMuth said, the Reagan administration has made "steady progress" in reducing regulation during its first three years, and he predicted that there would be a continued withering of economic controls in such industries as transportation, communications, energy, and financial services.

Walter Olson, associate editor of the American Enterprise Institute's *Regulation* magazine and a contributing editor of *National Review*, was not so optimistic in his comments.

"I do not want to take away from the Reagan administration its genuine accomplishments," Olson said, "but a commitment to regulatory reform ought to go beyond slowing down the flow of new regulation and simplifying compliance with existing regulations." He suggested that DeMuth's disclaimers about the political difficulty in achieving radical reform were perhaps inadequate, since the administration itself has even added regulations in areas where it has much executive discretion, and should have been less affected by political considerations. He cited as examples the imposition of import restrictions, a failure to abolish racial quotas used in hiring for federal contracts, and leaving intact certain bilingual education requirements enforced by the Department of Education.

The Policy Forum was attended by reporters from *The Wall Street Journal*, the *St. Louis Post-Dispatch, Barron's* and *Fortune*, as well as by Deputy Secretary Danny Boggs of the Department of Energy and Fred André, a member of the Interstate Commerce Commission.

A New Look at Development Economics

Policy Report Reviews

The Poverty of "Development Economics" *by Deepak Lal (London: Institute of Economic Affairs, 1983), 127 pp., $10.95.*

Only in the last thirty five years have economists fully addressed the question of economic development. The less developed countries (LDCs) were thought to be beyond the domain of standard economics, which uses the perfectly competitive model. In these countries markets were so backward and economic participants so different from the maximizing agents of the perfectly competitive model that unorthodox economic approaches were used in its stead. Not surprisingly, almost all the policy conclusions of these studies favored extensive economic planning of the domestic economy, government control of international trade, and massive foreign aid, arguing that these steps were necessary to get the LDCs off the ground. The domination of this outlook has been considerably undercut in the past fifteen years by free-market economists (notably P. T. Bauer), who have attacked the prevailing theories and presented the free market alternative. Also significant in weakening the domination of government-control ideas has been the remarkable success of the "Gang of Four"—Hong Kong, Singapore, South Korea, and Taiwan—which has patently demonstrated that government control and foreign aid are not required for rapid economic growth.

In IEA's *Hobart Paperback 16*, Deepak Lal continues the critique of development economics from a theoretical standpoint. Lal's primary objection to development economics is its often-made claim that standard neoclassical economic theory has little validity in the Third World. Development theorists in the past discarded the perfectly competitive model in analyzing LDCs because of extreme dissimilarities with the phenomena of the Third World: allocation based on tradition rather than efficiency, backward production methods rather than uniform technology with high substitutibility, the apparent lack of concern for economic reward among the actors rather than "economic man." By dropping the standard model, which generally suggests a laissez-faire policy, these theorists have tended to conclude that since LDC economies do not resemble perfect competition, economic activity can be rationally determined only by government planning.

Lal disagrees with this conclusion on two grounds. First, though the LDC economy cannot achieve the neoclassical welfare optimum (which perfect competition could) with free markets, this does not imply that government planning is necessarily the "second-best" solution. Rather, free enterprise may still be the "second-best" (which means it is the first-best of the *feasible* alternatives). He in fact shows historically that government direction has rarely led to desirable results and has often been the very source of the problem. Lal's second criticism is that neoclassical theory is much more applicable to the Third World than believed. Using historical evidence, he shows that people in LDCs have responded to economic incentives, abandoning social traditions and personal habits. Rapid market development and technological growth is what neoclassical theory would predict for unexploited economic settings, and it has been witnessed in Southeast Asia.

While Lal effectively uses standard theory to debunk many of the unorthodox theories of development, his firm attachment to the neoclassical paradigm hinders him as well by narrowing his outlook. In particular, his use of neoclassical welfare economics leads him down the wrong path. He feels the best economic system is the one which produces the highest social welfare—a notion which not only quantifies personal "utility," but also makes interpersonal utility comparisons. Government programs, likewise, should be based on rigid cost-benefit analysis. Lal feels that this would put development economics on a firm scientific basis.

It would be much wiser to approach the topic of economic development with less of a demand for "scientific objectivity," and with more of an interdisciplinary outlook. While sound economic principles are a requisite (which are included in the neoclassical doctrine and were neglected by the authors Lal criticizes), the assumptions and modes of analysis part and parcel to the neoclassical paradigm are more likely to be a liability than an asset in the investigation.

Productivity and Prices: The Consequences of Industrial Concentration, *by Steven Lustgarten (Washington: American Enterprise Institute, 1984), 52 pp., $4.95.*

Professor Lustgarten puts forth a brief statistical case for the claim that, contrary to common opinion, market concentration normally leads to higher productivity and lower prices. Covering the period 1947–1972 the data consider the *changes* in productivity and prices of industries as their concentration changed. On the basis of net exits and entries and of the change in the percentage market share of the four largest sellers, he uses four categories to classify industries as becoming much more concentrated, somewhat more concentrated, much less concentrated, and somewhat less concentrated. With each of these four classifications the respective average changes in productivity and prices are given. The data reveal a moderate correlation between more concentration and increasing productivity (relative to the rest of the economy), and decreasing price (also relative to the rest of the economy). Because of the study's lack of empirical detail and its conceptual shortcomings, however, it is less useful than it might be.

Without an integration with general history, statistical inference from data far more extensive than Lustgarten's could not be conclusive. Consider the following scenario: During and immediately after World War II many new firms entered industries experiencing rampant demands, and production efficiency was low due to rushed technology. In the following decades urgency declined and technology caught up so firms exited industries as better efficiency, lower demands, and lower prices occurred simultaneously. Meanwhile the exiting resources were shifted into dispersed activities—activities that offer profitability because of technological advance rather than a sudden demand. This scenario would yield Lustgarten's data, yet its prime cause—the war—lies outside of market mechanisms and is irrelevant to today's issues.

This hypothetical example demonstrates the limitations of Lustgarten's study. One must remain very skeptical of statistical arguments until they are meaningfully integrated into an historical explanation. His neoclassical theory also fails to offer any new insight

Other than presenting statistics, Lustgarten's study does little to advance the growing literature questioning government efforts to reduce industry concentration.

A Blueprint for Jobs and Industrial Growth, *edited by Richard B. McKenzie (Washington: Heritage Foundation, 1984), 80 pp., $4.00.*

This study is a useful antidote to much of the current debate over industrial policy. A brief introductory section outlines the guidelines that ought to be kept in mind when designing policies for economic growth. These rules include the efficiency of the market allocation process, the cost-effectiveness of privatizing many government services, the importance of free trade, the neutrality of tax policies, and the importance of competition in such diverse fields as labor and education.

Forty-three specific proposals for encouraging economic growth are advanced. Grouped in such categories as antitrust, regulation, taxation, environmental resources, and labor, they generally focus on repealing or easing laws that interfere with the market process. These include decontrolling natural gas, narrowing the scope of antitrust laws, privatizing bank deposit insurance, vouchers and tax credits for education, and a youth minimum wage. Each proposal is accompanied by references for futher information.

Those who are looking for a "free-market industrial policy" will find this booklet a good start.

Slashing the Deficit, *edited by John Palffy (Washington: Heritage Foundation, 1984), 110 pp., $4.00.*

This volume advances specific budget options that would reduce the fiscal year 1985 deficit by $119 billion. The recommendations have four themes: shifting responsibilities to state and local governments, user fees, privatization, and improved management and elimination of unnecessary programs.

The study makes clear that the deficit is a result of higher spending, not tax reduction, and warns that "raising taxes undermines incentives in the economy, does nothing to cure the deficit problem, and invites even bigger government." Even so, it proposes $24 billion in revenue increases in such measures as improved debt collection, repealing the additional federal income tax exemption for the elderly, taxing unemployment benefits and the tax-exempt health insurance premiums paid by employers, and a variety of user fees and land sales.

However, $95 billion of savings would come in reduced outlays. The largest proposed savings include reducing the federal share of pollution-treatment facilities, an end to farm deficiency and disaster payments, abolition of the Small Business Administration's general loan program, dramatic reductions in federal expenditures on highway construction and mass transit, and reform of the student loan program. Other large savings would come from reductions in spending on Medicare, Medicaid, and a variety of income transfer programs.

The Heritage Study proposes $9 billion of defense cuts by reforming retirement pay, closing many commissaries, allowing the Pentagon to close and consolidate military bases without congressional interference, and improving procurement and management.

It is unfortunate that the federal deficit has gotten so large that even dedicated budget-cutters can't find a way to eliminate it. Nevertheless, this study is an excellent guide to budget-cutting opportunities. If its authors looked at U.S. military expenditures with the same critical, zero-based perspective that they have used on domestic spending, they would presumably come even closer to closing the budget gap. ■

Adjunct Scholars (Cont. from p. 13)

current regulation of electric utilities for the Arizona Corporation Commission. Among his recent articles are "Property Rights: From Ancient Origins and Spontaneous Invention to Conscious Design?" in *Progress in Natural Resource Economics* (Oxford University Press), "Natural Monopoly and the Contestable Markets Hypothesis" (with Don Coursey and Mark Isaac) in *Journal of Law and Economics*, and "OCS Leasing and Auctions: Incentives and the Performance of Alternative Bidding Institutions" (with James Cox and Mark Isaac) in *Supreme Court Economic Review.*

Richard H. Timberlake, Jr., of the University of Georgia has recently published "The Central Banking Role of Clearinghouse Institutions" in the *Journal of Money, Credit and Banking* and is working on articles on monetary and banking theory.

Jennifer Roback of Yale University has become a research fellow of the Manhattan Institute and a director of the Taxpayers Foundation. As a result of her Cato op-ed article in April, she has become a regular columnist for the *St. Louis Globe-Democrat*. Her article "Southern Labor Policy: Exploitive or Competitive?" will appear in the *University of Chicago Law Review*, and she will have an article on public goods in an upcoming book from the National Bureau of Economic Research.

John Baden, director of the Political Economy Research Center, is the editor of *The Vanishing Farmland Crisis: Critical Views of the Movement to Preserve Agricultural Land* (University Press of Kansas). He was appointed to the National Petroleum Council by Energy Secretary Donald Hodel and has recently written on environmental issues for the *Denver Post* and the *Rocky Mountain News*. ■

"To be governed..."

It's a dirty job, but somebody's got to do it

Attorney General William French Smith's twenty-three day trip around the world in 1982 to campaign for greater drug control efforts cost more than $683,727. . . .

That figure, however, does not include salaries or hotel charges for sixteen Justice Department officials and eleven FBI agents who went along, nor any of the expenses for six officials from the State Department, the Drug Enforcement Administration and the Immigration and Naturalization Service.

—*Washington Post*, April 17, 1984

OK, as long as it doesn't do anything else

If you believe that the government does nothing useful, you're wrong: It publishes the [Statistical] Abstract.

—*Washington Post*, April 4, 1984

Charity begins at home

Presidential candidates Senator Gary Hart (D-Colo.) and Jesse L. Jackson have called for more welfare for the poor. . . . They certainly don't intend to contribute out of their own pockets. Last year, Hart donated $320 to charity out of a $125,474 income. Jackson gave $500 out of $115,109.88 in earnings.

—Jack Anderson in the *Washington Post*, May 12, 1984

Flash: sun to rise in east

A new plan to allow property tax collections in Prince Georges County to grow . . . is winning the support of county officials.

—*Washington Post*, May 10, 1984

True or false: the U.S. Capitol is located . . .

Several U.S. Senate candidates appearing on a television news quiz last night had trouble naming Israel's prime minister and the sides the United States has taken in Central America. . . .

When [WBZ-TV reporter Andy] Hiller asked the candidates if they thought the quiz was fair, [candidate David] Bartley said the questions would have been more appropriate to ask of a secretary of state than a candidate for senator.

—*Washington Post*, April 4, 1984

How do you spell "Potemkin" in Chinese?

President Reagan returned to the United States today with praise for the "free-market spirit" he said is enlivening "so-called communist China."

—*Washington Post*, May 2, 1984

Birds of a feather

The issue in Washington now is not whether taxes should be raised, but rather how to increase them. . . . "The middle class will get hit because, to borrow the line about why Willie Sutton robbed banks, that's where the money is," says tax lobbyist Charls E. Walker.

—*Business Week*, March 26, 1984

P-O-R-K, as in barrel

When the [Maryland] House Appropriations Committee passed out the sought-after construction funds . . . the pickings were slim. But the committee managed to scrape up a few million dollars for some legislators' pet projects—including $161,000 for a historic tavern in Cecil County, $500,000 for a swimming pool in Federick County and $750,000 for a small park in Baltimore.

The sponsors of all the lucky projects had one thing in common: They had voted in favor of the controversial pension bill that House leaders got passed after weeks of struggle earlier this session. . . .

Tuesday, when Delegate Nathaniel Oaks (D-Baltimore) was asked how he ended up with $750,000 for Leakin Park back home, he said, "Well, I wouldn't call it a deal, but before making a commitment on pensions, it was discussed as one of the things I wanted."

—*Washington Post*, April 5, 1984

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