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A Plea for (Mild) Deflation

by George Selgin

In recent years the central bankers of the world's most advanced economies have come close to achieving a goal that seemed unreachable two decades ago: the eradication of inflation. In the United States, for instance, the consumer price index (CPI) rose only 1.6 percent in 1998. Yet, just as the elusive goal of price stability has come within their grasp, the central bankers are getting cold feet: a little inflation, they now tell us, is a price worth paying to avoid an even worse menace: deflation, or *falling* prices.

Deflation. For many people the word conjures up images of the Great Depression, when prices fell dramatically throughout most of the world. The decline in prices was the counterpart of collapsed sales, widespread bankruptcies, and armies of unemployed workers. If a little inflation is the only guarantee against another calamity like that of the 1930s, then it is, indeed, a price worth paying.

The truth, however, is that deflation need not be a recipe for depression. On the contrary, a little deflation can be a good thing, provided that it is the right kind of deflation.

Since the disastrous 1930s, economists and central bankers seem to have lost sight of the fact that there are two kinds of deflation—one malign, the other benign. Malign deflation, the kind that accompanied the Great Depression, is a consequence of shrunken spending, corporate earnings, and payrolls. Strictly speaking, even in this case, it is not so much deflation itself that is harmful as its underlying cause, an inadequate money stock. The hoarding of money, or its actual disappearance (the quantity of money in the U.S. economy actually shrank 35 percent between 1930 and 1933), causes the demand for goods and services to dry up. In response, firms are forced to curtail production and to lay off workers. Prices fall, not because goods and services are plentiful, but because money is scarce.

Benign deflation is something else altogether. It is a result of improvements in productivity, that is, occasions when changes in technology or in management techniques allow greater real quantities of finished goods and services to be produced from a given quantity of land, labor, and capital. Because an increase in productivity is the same thing as a decline in unit costs of production, a productivity-driven decline in the prices of finished goods and services needn't involve any decline in producers' earnings, profits, or payrolls. Lower costs are matched by correspondingly lower consumer prices, *not* by lower wages or incomes. Such productivity-driven deflation is actually good news to the

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George Selgin is associate professor of economics at the University of Georgia, an adjunct scholar of the Cato Institute, and the author of The Theory of Free Banking *and* Less Than Zero: The Case for a Falling Price Level in a Growing Economy.

Carolyn Weaver (left) of the American Enterprise Institute and Michael Tanner (right) of the Cato Institute teamed up on Gene Sperling, director of President Clinton's National Economic Council, at Cato's February 12 Policy Forum on Clinton's Social Security reform plan.

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The GOP: Slouching toward Irrelevance

There was a time when both of the major parties stood for things worthwhile. Now is not such a time. Republicans used to focus on the enumerated powers of government: the Constitution limited the role of government in our society and the GOP thought that was good. Democrats tended to focus more on the Bill of Rights (or some of them) and were defenders of freedom of speech and civil liberties.

Republicans fought excessive red tape and the bureaucracy. Democrats warned of the dangers of the promiscuous use of military force around the world. All that was laudable. And all that has changed.

Today there seems to be no aspect of civil society that either party would place beyond the reach of the federal leviathan. Neither Barry Goldwater nor Ronald Reagan believed there was a federal role in education in America. Now, GOP Senate Majority Leader Trent Lott whines that Bill Clinton is not giving Lott's party credit for the billions of dollars it wants to spend on local education. Democrats today would trample the First Amendment in the name of "campaign finance reform" and politically correct speech codes. Republicans offer bills to provide federal funding for pre-divorce counseling. Democrats cheer Bill Clinton's utterly undisciplined use of military force for "humanitarian" reasons, collateral damage be damned. Both parties are unwilling to admit that Social Security must be privatized.

"The GOP needs to reclaim responsibility for the defense of limited government."

It's all very disheartening for those of us who advocate limited government and individual liberty. Perhaps most disturbing has been the virtual collapse of the GOP as a defender of a constitutionally limited role for the federal government. For better or for worse (for worse, as it turns out), the Republican Party has been perceived as the major party advocating less government for most of this century. Why has the GOP seemingly thrown in the towel with respect to limiting the size and scope of government?

The answer lies, at least partially, in several tacks the GOP has taken on the path of least resistance:

The Balanced Budget Obsession. Many conservatives, confronted with continuous federal deficits, found it was easier to don the mantle of fiscal responsibility than to argue the merits of a given program. Rather than debate whether a federal school lunch program was within the scope of legitimate federal power (who can be against hungry poor kids, after all?), it was far easier to point out that we simply didn't have the money to fund the program.

The Supply-Side Revolution. When Jack Kemp, Newt Gingrich, Vin Weber, Connie Mack, and the rest discovered Jude Wanniski and Art Laffer, they thought they'd died and gone to heaven. In supply-side economics they found a philosophy that gave them a free pass out of the debate over the proper role of government. Just cut taxes and grow the economy: government will shrink as a percentage of GDP, even if you don't cut spending. That's why you rarely, if ever, heard Kemp or Gingrich call for spending cuts, much less the elimination of programs and departments.

Both the fiscal conservatives and the supply-siders would have done well to remember Milton Friedman's admonishment that the true tax on the American people is the level of government spending, whether it is financed by taxes or by borrowing.

The Scandalmongers. Another cop-out in the battle of ideas is to focus on opponents' scandals rather than the issues. This approach was particularly appealing to Gingrich, who vowed never to give a speech without mentioning Monica Lewinsky. The 1998 elections were a disaster for the GOP precisely because the party's leadership abandoned the small government rhetoric of 1994 and opted instead for the expected windfall from President Clinton's scandals. Meanwhile, the Democrats ran on issues (bad ones to be sure, but issues nonetheless) and for their efforts picked up seats in the House.

The Judicial Restraint Crowd. The Supreme Court is the ultimate venue in the battle for limited government. It was to be, in James Madison's words, "the bulwark of our liberties" against the majoritarian onslaught from the two political branches of the federal government. But even here the conservatives who dominate the GOP are raising the white flag. Burned by such decisions as *Brown v. Board of Education* and *Roe v. Wade*, GOP conservatives created out of whole cloth a judicial philosophy intended to eviscerate the power of the Court. Robert Bork and Justice Antonin Scalia are the intellectual leaders of the "judicial restraint" crowd, which claims adherence to "original intent" but which in practice would radically restrict the role of one of the three branches of the federal government, thus undermining the Framers' carefully calculated balance of power. Scalia believes, for instance, that the General Welfare Clause effectively gives plenary power to Congress to intervene in civil society wherever it pleases. Yet it was Madison who said that an expansive interpretation of the General Welfare Clause would turn the Constitution on its head.

A proper role of the Supreme Court is to take seriously the Enumerated Powers Doctrine and the Tenth Amendment and actively strike down legislation that is outside the powers granted Congress in Article 1, Section 8, of the Constitution. We need principled judicial activism. "Judicial restraint," as advocated by many conservatives, is yet another capitulation in what should be a battle of ideas over the role of government in a free society.

Before the Republicans and Democrats morph into one party that micro-manages our lives from Washington, the GOP needs to reclaim responsibility for the defense of limited government. By continuing on its current path it is merely slouching toward irrelevance.

Ed Crane

—Edward H. Crane

Searching for free traders in Congress

5 Million Workers Opt Out of Social Security

Approximately 5 million state and local government workers are reaping rewards outside the current federal Social Security system. In "State and Local Government Retirement Programs: Lessons in Alternatives to Social Security" (Social Security Paper no. 16), Cato policy analyst Carrie Lips examines local retirement plans in both San Diego and Galveston, Texas, and state plans in Louisiana, Ohio, and Massachusetts. "These plans provide useful information about the benefits and hazards of some aspects of retirement programs—information that should guide the debate about the future of Social Security," Lips writes. Some local retirement plans, including one in San Diego, are defined-contribution plans that allow workers to put their retirement money into personal accounts that offer "greater returns and individual ownership of retirement savings." Lips recommends that instead of allowing the federal government to invest Social Security trust fund money in the stock market, policymakers "should adopt the structure of a defined-contribution plan by giving individuals the option to redirect payroll taxes to accounts that they would own and invest."

◆Few Free Traders in Congress

In the first comprehensive rating from a free-market perspective of individual members of Congress on how they voted on trade and international subsidy issues, Daniel T. Griswold found that only 37 members (25 of the House, 12 of the Senate) of the 105th Congress were real "free traders." Sen. Wayne Allard (R-Colo.), who voted for free trade and against subsidies on all six major votes surveyed, ranked highest in the study "Free Trade, Free Markets: Rating the 105th Congress" (Trade Policy Analysis no. 6). Two senators, Carl Levin (D-Mich.) and Olympia Snowe (R-Maine), opposed free trade and supported subsidies on every major vote. Griswold, associate director of Cato's Center for Trade Policy Studies, found that members of the 105th Congress can be classified in four categories: free traders, who support trade and oppose subsidies; internationalists, who support both trade and subsidies; isolationists, who oppose both trade and subsidies; and interventionists, who oppose trade and support subsidies. "Members of Congress do not need to choose between the isolationism of Pat Buchanan and the internationalism of President Clinton. They can choose to vote for a coherent agenda to liberalize trade and eliminate subsidies," writes Griswold.

◆Universal Preschool's False Start

Although preschool programs provide no lasting benefits to disadvantaged children, and middle-class children gain little if anything from preschool, legislators across the country are deciding whether to provide no-fee prekindergarten classes for all three- and four-year-olds. In "Universal Preschool Is No Golden Ticket: Why Government Should Not Enter the Preschool Business" (Policy Analysis no. 333), entitlements policy analyst Darcy Olsen warns that the desire to "do some-thing" should be tempered by the facts. In an extensive review of research done on the subject over the past 35 years, she finds that, despite the assertion of advocates of public preschool that early schooling of low-income children is an investment that pays off, there is no empirical evidence that such programs reduce "the number of children who perform poorly in school, become teenage parents, commit criminal acts, or depend on welfare." In fact, studies show that any initial gains the children make disappear entirely within a few years of exiting the programs.

Darcy Olsen discusses Head Start on NBC's *Today*.

◆Endless Search for Enemies

Although both congressional leaders and the president have proposed higher military spending next year, a study from the Cato Institute says that "the time has come to reduce U.S. defense spending to match the benign threat environment in the world today." In "Tilting at Windmills: Post–Cold War Military Threats to U.S. Security" (Policy Analysis no. 332), Ivan Eland points out that strategic realities have been altered

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Forums and testimony on Kosovo, taxes, feminism, law

Sperling Defends Clinton Social Security Plan

◆**February 4:** Doom and gloom have been the major message coming from the media for much of the last three decades. At a Book Forum for the newly released book ***Myths of Rich and Poor***, Cato Institute adjunct scholar W. Michael Cox and journalist Richard Alm said that the negative impression given by the media is not just wrong but spectacularly wrong. Living standards are much better, Cox and Alm said, when we consider that we have more assets, more leisure time, and higher quality goods. The poor are also better off than they've ever been; they possess a range of material goods that weren't available even to middle-class families just three decades ago.

◆**February 11:** At a Book Forum to celebrate the release of her new book, ***Ceasefire! Why Women and Men Must Join Forces to Achieve True Equality***, Cathy Young of the Women's Freedom Network argued that feminism today has become a divisive force used by women against men. She also criticized conservatives for seeing the gains of women in business and the professions as a symptom of family breakdown. Syndicated columnist Mona Charen said that feminists were unwise to attack chivalry because it was often a benefit for women and that Young should not attack chivalry in the name of equality.

◆**February 11:** José Piñera, co-chairman of Cato's Project on Social Security Privatization, testified before the **House Ways and Means Committee** on the success of Chile's conversion from a pay-as-you-go retirement system to a fully funded privately administered system. Piñera, Chile's former minister of labor and social security who privatized the country's retirement system almost two decades ago, was the committee's sole witness. He called Chile's old pension system "a one-size-fits-all scheme that exacts a price in human happiness," in contrast with the successful new system that allows a worker "to determine his desired benefits and retirement age in the same way one can order a tailor-made suit."

◆**February 12:** At a Policy Forum, "**Clinton's Plan for Social Security: An Evaluation,**" Gene Sperling, assistant to the president for economic policy and director of the National Economic Council, said the economic logic behind President Clinton's Social Security reform proposal is "simple and sound." Carolyn Weaver, resident scholar at the American Enterprise Institute, said the president's proposal ignores the imminent explosion of benefit costs and doesn't save Social Security. Michael Tanner, Cato's director of health and welfare studies, complimented the administration for being willing to discuss Social Security reform, but he expressed disappointment at the proposal that the federal government invest Social Security funds in the stock market, which could result in greater government intervention in the economy. Tanner noted that the plan won't make Social Security solvent; will fail to give the rate of return that the market can provide; will still discriminate against the poor and minorities, who on average have shorter life spans than the population as a whole; and won't give Americans a legal right to their Social Security benefits.

◆**February 12:** On the same day the U.S. Department of Commerce released preliminary findings in the major steel antidumping cases, the Cato Institute held a Policy Forum titled "**Steel Imports: The Other Side of the Story.**" Mustafa Moharatem, chief economist of General Motors, questioned whether the steel industry is really going through a crisis. He pointed out that 1997 was a record year for steel and that the demand for steel fell as a result of the GM strike. Jon Jenson, president of the Precision Metalforming Association, argued that the historical record shows that steel quotas don't work. They threaten the availability of steel for steel-using industries, resulting in higher prices, longer delivery times, and deteriorating quality.

◆**February 16:** Should NATO intervene in Kosovo? That question was discussed at a Cato Policy Forum titled "**Kosovo: The Prospects and Perils of NATO Intervention.**" Col. Harry Summers (Ret.), distinguished fellow at the Army War College, said Americans will support sending Americans troops abroad when they can clearly see the national objective. Ivo Daalder, visiting fellow at the Brookings Institution, said the credibility of NATO is on the line in Kosovo. Cato foreign policy analyst Gary Dempsey called Clinton's rationale for sending troops into Kosovo "incoherent" and argued that such a policy is contrary to the national interest.

◆**February 17–21:** The Cato Institute hosted its annual **Benefactor Summit** at the Melia Los Cabos Resort in Los Cabos, Mexico. More than 130 Cato benefactors heard talks and reports from Cato scholars. In addition, Alan Kors of the University of Pennsylvania discussed the betrayal of liberty on America's college campuses; James Glassman of the *Washington Post* discussed libertarianism in the context of contemporary American politics; Stephen Davies of Manchester University discussed the wealth explosion that followed the Industrial Revolution; and former *Cheers* scriptwriter and producer Rob Long delivered the Saturday evening address.

◆**February 17:** Shortly after the U.S. Court of Appeals for the District of Columbia Circuit struck down the Federal Drug Administration's dietary supplements health claims review process on the grounds that it was arbitrary and violated commercial speech rights under the First Amendment, the Cato Institute held a Policy Forum titled "**Regulating Health Claims vs. Free Speech: Implications of the Court's Ruling against the FDA**" to discuss the implication of the court's ruling. Jonathan Emord, attorney for the plaintiffs, argued that the FDA has taken a paternalistic approach to regulation. Emord noted that the FDA has approved only two claims for dietary supplements since 1990. Charles B. Simon of the Simon Cancer Prevention Institute described how FDA regulations have prevented the results of medical research from reaching the American public in a timely manner. David Vladeck, director of Public Citizen, warned that some ill Americans may fall prey to hucksterism and rely on dietary supplements when they should be seeking proven therapy.

◆**February 22:** At a Book Forum for the release of her new book, ***The Greedy Hand: How Taxes Drive Americans Crazy and***

What to Do about It, *Wall Street Journal* editorial writer Amity Shlaes said that the "greedy hand" of government is a "hidden hand" that surreptitiously confiscates the wealth of Americans. Rep. Jennifer Dunn (R-Wash.) and Wendy Lee Gramm, distinguished senior fellow at the Mercatus Center, commented.

◆**February 25:** Daniel T. Griswold, associate director of Cato's Center for Trade Policy Studies, told the **House Ways and Means Subcommittee on Trade** that protectionist legislation aimed at foreign steel producers will make "millions of American workers and tens of millions of American consumers worse off so that the domestic steel industry can enjoy temporary benefits."

◆**February 26:** The recent legislation by cities to recover for the medical costs of gun-related violence was the topic of a Cato Policy Forum, **"Cities Sue the Gun Industry: Anti-Violence Mandate or Litigation Tyranny?"** David B. Kopel, research director of the Independence Institute, contended that manufacturers should not be held responsible for the actions of third parties. He suggested that a "loser-pays" system might prevent frivolous lawsuits intended to bankrupt industries. Jonathan E. Lowy, staff attorney at the Center to Prevent Handgun Violence, said that the Second Amendment doesn't guarantee the right to bear arms. He defended the lawsuits by the states, arguing that juries have a right to decide if negligence laws should be applied to the gun industry.

◆**March 2:** At a Book Forum for his new book ***Jury Nullification: The Evolution of a Doctrine***, Houston lawyer Clay Conrad defined jury nullification as "the act of a criminal trial jury refusing to convict in spite of proof of guilt, because they believe that the law is unjust, or unjustly applied." Conrad contended that juries are entitled to nullify unjust laws and that attorneys and trial judges should inform jurors of this prerogative, as the Founding Fathers intended. Joseph DiGenova, former U.S. attorney for the District of Columbia, argued that instead of nullifying laws, people can vote, run for office, or crusade against laws they don't like. Randy Barnett, professor of law at Boston University and a former prosecutor, countered that jury independence is part of the checks and balances on government.

◆**March 3:** Michael Tanner, director of Cato's Project on Social Security Privatization, told the **House Ways and Means Subcommittee on Social Security** that investing the Social Security trust fund in capital markets is fraught with peril. "Allowing the federal government to purchase stocks would give it the ability to obtain a significant, if not a controlling, share of virtually every major company in America." Tanner warned that "there are serious problems with the entire concept of allowing the federal government to invest directly in private capital markets. The result could potentially be a government bureaucrat sitting on every corporate board."

Warren Coats of the International Monetary Fund raises a question at Cato's March 16 forum on "dollarization" in Latin America.

Cato associate policy analyst Cathy Young discusses her new book, *Ceasefire! Why Women and Men Must Join Forces to Achieve True Equality*, at a February 11 Book Forum.

Cato's Michael Tanner and former Congressional Budget Office director Robert Reischauer testified before the House Ways and Means Subcommittee on Social Security on March 3.

◆**March 4:** Solveig Singleton, director of information studies at Cato, told the **House Judiciary Committee's Subcommittee on Commercial and Administrative Law** that "the Federal Deposit Insurance Corporation's proposed 'Know Your Customer' rule forces banks to become agents of the police, spying and reporting on their own customers—without ever obtaining a warrant."

◆**March 9:** While administrative costs for personal retirement accounts are likely to be higher than for Social Security, "the difference should be insignificant particularly when compared to the benefits offered by personal retirement accounts," Chicago economist Robert Genetski said at a Cato Policy Forum, **"Administering a Privatized Social Security System: Can It Be Done?"**

◆**March 10:** Cato Institute senior fellow Doug Bandow told the **House International Relations Committee** that the Clinton administration's Kosovo policy is an attempt to "micromanage a guerrilla conflict." The plan to bomb Serbia and initiate the long-term occupation of Kosovo is "misguided in the extreme." Bandow also told the committee that the administration is putting U.S. troops at risk "without any serious, let alone vital, American interests at stake."

◆**March 11:** On the eighth anniversary of the conclusion of the Persian Gulf War, U.S. strategic and diplomatic policy is adrift. The U.S. government has spent more than $9 billion to contain or change the regime in Iraq. At a Cato Policy Forum, **"Washington's Iraq Policy: What's Next?"** Ted Galen Carpenter said that U.S. policy in Iraq is a "case study in foreign policy bankruptcy." The United States should consider withdrawing its forces from Iraq to limit U.S. exposure to terrorism. John Bolton, former assistant secretary of state for international organization affairs, said the Bush administration's policy in Iraq was "too limited"; the goal should have been the

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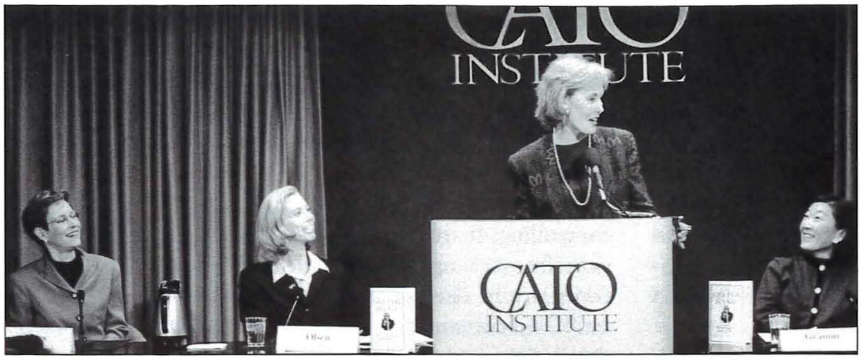
EVENTS *Continued from page 5*

overthrow of Saddam Hussein. Amb. Edward Peck, former chief of mission at the U.S. Embassy in Iraq, argued that Washington should talk directly to Saddam Hussein, just as it has spoken to other tyrants.



A forum sponsored by Cato and the Independent Women's Forum featured author Amity Shlaes, Cato's Darcy Olsen, Rep. Jennifer Dunn, and Wendy Lee Gramm of the Mercatus Center.

◆**March 16:** Should countries dollarize their economies to contain the financial turmoil that is plaguing many developing economies? At a Cato Policy Forum, **"Dollarization for Latin America?"** Steve Hanke of Johns Hopkins University said that Latin American countries should unilaterally dollarize. That would minimize exchange rate risks, end currency crisis problems, and allow consumers to choose the kind of currency they want. Guillermo Calvo of the University of Maryland said that emerging markets should dollarize but warned that there should be lenders of last resort for struggling countries. William Niskanen, Cato's chairman, said that the U.S. government shouldn't promote a general dollarization of Latin America but should accommodate the dollarization of any specific Latin American country that seeks to dollarize.

◆**March 16:** The same week both houses of Congress took up bills proposing a national missile defense, the Cato Institute held a Policy Forum on the issue. At **"National Missile Defense: Which Path Is Best?"** Steve Andreason of the National Security Council said that the administration has three main goals when considering deploying an NMD: (1) reducing nuclear arms, (2) maintaining the Anti-Ballistic Missile Treaty, and (3) countering rogue states. Charles Peña, a consultant on missile defense, said that the time has come to consider real strategies for countering the real threats that America faces from foreign powers and rogue states.

◆**March 17:** Economist Peter Bauer once quipped, "Aid is thus like champagne: in success you deserve it, in failure you need it." The efficacy of foreign aid was discussed at a Policy Forum, **"Is Foreign Aid Like Champagne? Assessing Overseas Assistance."** A new study from the World Bank concludes that much of the foreign aid handed out in the post–World War II era has been "an unmitigated failure." David Dollar, a principal author of the World Bank study, contended that reasonable amounts of foreign aid can contribute to strengthening the benefits of political reform, make persistence of reform more likely, and create a better environment for poverty reduction. Nicholas Eberstadt of Harvard University questioned both the aid agencies' ability to reform and the new rationales for aid at a time when countries are already liberalizing their economies.

◆**March 22:** The Clinton administration has requested two more rounds of military base closures in fiscal years 2001 and 2005. The Cato Institute cosponsored with the Business Executives for National Security a Policy Forum, **"The Economic Effects of Closing Military Bases,"** to discuss the topic. Paul Dempsey, director of the Department of Defense's Office of Economic Adjustment, said that cutting the base closure time frame from 68 to 44 months has saved the military money and motivated communities to reorganize their local economies more quickly. Jeffrey Simon, president of the National Association of Installation Developers, said it is easiest to rejuvenate communities when private developers help lead the transition.

Cato foreign policy analyst Gary Dempsey was among the speakers at a February 16 forum on the Kosovo crisis.

◆**March 23:** Roger Pilon, founder and director of Cato's Center for Constitutional Studies, told the **House Subcommittee on the Constitution** that Congress should not amend the Constitution to prohibit flag desecration. "In a free society, individuals have a right to express themselves, even in offensive ways. This amendment, as it tries to shield us from offensive behavior, gives rise to even greater offense. By offending our very principles, it undermines its essential purpose, making us all less free."

◆**March 24:** The Cato Institute held a City Seminar in Miami on **"Liberty in the New Millennium."** Speakers included syndicated columnist Robert Novak and the Cato Institute's Edward H. Crane, Steve Moore, José Piñera, and Roger Pilon.

◆**March 25:** A Cato Institute City Seminar was held in Palm Beach, Florida, on **"Liberty in the New Millennium."** Speakers included syndicated columnist Robert Novak and the Cato Institute's Edward H. Crane, Steve Moore, José Piñera, and Roger Pilon. ■

How Taxes Drive Americans Crazy

On February 22 the Cato Institute and the Independent Women's Forum held a Book Forum for Amity Shlaes, an editorial writer at the Wall Street Journal *and the author of* The Greedy Hand: How Taxes Drive Americans Crazy and What to Do about It. *Rep. Jennifer Dunn (R-Wash.), a member of the House Ways and Means Committee, commented.*

Amity Shlaes: As a *Wall Street Journal* editorialist on tax policy, I covered the rise and fall of taxes as an issue in the 1996 presidential campaign. It was clear that, on one hand, the tax issue was important. Steve Forbes's success was clearly due to the bold way he led on taxes. On the other hand, it was clear that taxes weren't entirely penetrating. There was a terrible disconnect. Polls showed that people were eager for tax relief, and the politicians knew that they should give tax relief and even had their concrete solutions. Yet there wasn't complete communication. The failure to communicate was, I think, for the Republicans, part of the greater failure of their presidential campaign.

After that campaign, it seemed to me that it was time to look at the problems the average American experiences. In other words, I chose to delve into what I call the culture of tax. I started my research by going to H&R Block tax school. I looked at taxes the way the average man does when he wrestles with Form 1040, when he pays sales taxes, when he fights the local school board, when he plans his retirement.

Unfortunately, many of our tax-cutting politicians are making a mistake. They're acting as though tax problems today are the same as they were in the 1970s. But in a sense the politicians are fighting the wrong war. The 1990s' tax experience is very different from the experience of the 1970s. The 1970s' and the early 1980s' tax troubles were generally income tax troubles—troubles made acute by the ravages of inflation. The tax problems of the 1990s have a range of sources that are general and hard to understand. In other words, today's problems are not acute, they're chronic. That explains why voters are both angry and disaffected.

The best image for depicting this modern tax discontent comes from Thomas Paine, the publicist and agitator who played such an important role in our country's founding. Paine wrote the following in *The Rights of Man:* "If, from the more wretched parts of the old world, we look at those which are in an advanced state of improvement, we still find the greedy hand of government thrusting itself into every corner and crevice of industry, and grasping the spoil of the multitude. Invention is continually exercised to furnish new pretense for revenue and taxation. It watches prosperity as its prey and permits none to escape without tribute."

We're prosperous today, and yet the government takes a lot. Here we are in the age of the freest markets, and we should be celebrating the invisible hand of Adam Smith, but it's Paine's hand, the greedy hand, that's growing. In fact it's growing even faster than the invisible hand at this point. Government is taking a greater share of the economy than it has at any point in our history except during wartime.

Amity Shlaes: "Government is taking a greater share of the economy than it has at any point in our history except during wartime."

For several reasons I like this hand image. The first is that it's kind of disembodied and creepy, which is just the way people feel about taxes today. We know there's a problem; we don't know why it bothers us. There's another thing about the hand that voters recognize and don't like: it's not only greedy, it's meddling. Although lawmakers are giving up on social engineering through entitlement, they are not giving up on social engineering itself, unfortunately. All the energy that used to be applied to writing welfare law is now poured into editing individual lives through the tax code. And finally, perhaps the worst thing about the greedy hand is that it's hidden. In other words, we've constructed a tax structure that works too well. In France, long ago, it was said that the art of taxation consisted in plucking the maximum feathers from the goose with the least hissing. And that's what we have today. It doesn't mean that the goose is happy.

Everyone is well aware that there's a problem with Social Security, but lawmakers, for whatever reason, tend to focus on the pension end of it. They work to ensure that the pensions of future senior citizens will match the generous ones today's seniors get, and they don't always show much understanding of the onerous nature of the payroll tax burden borne by those paying into the system. The payroll tax is the tax on low earners. It's the biggest tax on 7 of 10 filing households; it's the tax on labor and industry; it's the tax that makes the lives of younger earners, our children, unfairly grim. And if you want to think about how high the payroll tax is, consider this: Today's payroll tax rate, at over 7 percent, just on the employee side, is higher than the rate millionaires paid when the income tax was instituted in 1913. Then, the top rate was 7 percent.

Why has this happened? The answer probably isn't malice or hostility. I would say it's amnesia. The current high payroll tax rate isn't part of the personal experience of lawmakers or other people in the political leadership. When Alan Greenspan or Bill Clinton was younger, payroll tax rates were much lower; in time, payroll tax rates moved to their current terrible high. But most politicians and most leaders don't feel that. That's because many of us have moved above the cap; we've moved past the point where we continue to pay payroll tax on our income. So our actual average personal payroll tax rate is lower. We don't feel what it's like for someone starting out. We just can't relate to that experience.

Then there are sales taxes. Politicians treat them as ancillary matters, and you see static analyses of state revenue departments that assume that states can capture

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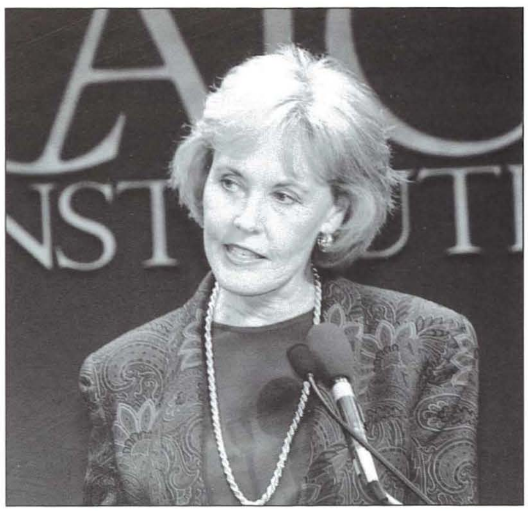
“It’s time for big income tax cuts, broad cuts. The enemy is the overall burden.”

POLICY FORUM *Continued from page 7*

new revenue simply by raising rates. But Americans have already developed an extensive culture of sales tax avoidance. People shop for tax breaks the way they shop for sales. A good example is the Mall of America, the nation’s largest tourist destination. But it’s also a prime example of tax avoidance. People go to Minnesota and to the mall because Minnesota has no sales tax on clothing. I think it’s important to recognize, therefore, that when Americans choose to cross the state line to go from New York to New Jersey, or from the District of Columbia to another jurisdiction, just to save pennies on sales tax, they’re actually telling government something. They’re saying, this amount is too much. Or, this I won’t pay. They send the same message when they choose to order from L.L. Bean or any other mail order house that enables them to escape state sales tax. Internet shopping is another example of this message. The fury that erupted when state revenue departments tried to tax Internet shopping was American tax rage. Today’s tax shoppers, as I call them, are milder than the citizens who boarded ships and dumped tea into Boston Harbor, but they are the direct descendents of those revolutionaries and they are communicating with their lawmakers.

And that brings us to income tax itself. In recent decades we’ve tended to think that any new tax fix will please voters. The Taxpayer Relief Act had many good things in it, but it was a classic example of what I’m talking about. The act was called relief and it changed hundreds of items in the tax code, but change and complexity are themselves trouble. Citizens don’t like change, and today we are not only changing the tax code but accelerating the rate of change. Americans have an ambivalent relationship with their professional tax preparers. You can interpret the rise of H&R Block as an expression of the unease Americans feel about the federal code. The more uncomfortable we are about talking to government directly and interacting with the Internal Revenue Service, the more likely we are to hire professional tax preparers. Professional protectors, you might call them. And when the Taxpayer Relief Act was passed, Block was very happy. Their commercials followed the news. But they weren’t happy commercials in the sense that they said, “Oh wonderful new tax breaks for you.” The theme song of those commercials after that act was “Someone to Watch over You.” Block knew that the best marketing strategy was to play to taxpayers’ fear of complexity. That, by the way, explains why Congress raced to pass its IRS reform in 1998, a very important reform. The complexity problem is a bad one though, and it’s a reason for some of the IRS rage. And in that sense the reform was a detour around the real problem. For the real problem isn’t the messenger, however demonlike the IRS bureaucracy seems; it’s not the IRS for all its evils; it’s the tax code and its complexity.



Jennifer Dunn: “Women care a lot about taxes these days. Women are starting businesses at twice the rate of men.”

Finally, there is progressivity, the fact that rates move up as we begin to succeed. I call this the ultimate success tax. Today we don’t have inflationary bracket creep, the way we did in the 1970s, but we do have another kind of bracket creep, real bracket creep. This is due to our prosperity, something that has nothing to do with government. We find ourselves in higher brackets than we ever imagined being in. Unfortunately, the recent fondness for credits has, to some degree, exacerbated the progressivity problem. The new credits are fine, as long as you fit into the income category that is entitled to those credits. But when people begin to earn more and move out of that category, they lose the credits and they face very high effective marginal tax rates. They pay a lot more in tax on the last dollar they earn than the statute actually says they pay. This is hidden progressivity, as opposed to visible progressivity, and most voters can’t articulate what the trouble is. They only know that the experience is bitter.

Lawmakers should be tackling this issue straight on. Instead, they’re avoiding it, just as they’re avoiding it in the marriage penalty debate. Perhaps motivated by polls on this issue, people have tried to fix the marriage penalty. But the marriage penalty is very hard to fix, and that’s one reason the legislation stalled. Everyone who works on the marriage penalty discovers that you can’t fix it, at least not in a deep way, without addressing progressivity. The marriage penalty debate is, again, really a proxy, a side debate, when actually maybe it’s time to take on progressivity itself. And for whatever reason, we’re not ready to do that or haven’t been.

There are several lessons you can draw from all of this. One is that the greatest economic philosopher on tax theory isn’t Milton Friedman, the champion of free markets, but James Buchanan, an economist who won a Nobel Prize for founding a school of thought called public choice theory. Public choice theory says that government is like a crustacean: it’s reflexive, it’s mindless, it will do anything to survive. It will even cannibalize other parts of government. How else can you explain the growth of the tax code and of our tax troubles overall?

The next lesson, I would argue, is that it’s time for big income tax cuts, broad cuts. Little cuts and little fiddles won’t do anymore. The IRS isn’t the enemy, and even the targeted little troubles aren’t the enemy. The enemy is the overall burden.

And last, I would say there is a cost to delaying. A number of lawmakers are distressed that taxes don’t always rank number one when voters are polled about what they want changed. But it’s natural that voters don’t want to ask for tax cuts. They’ve learned, unfortunately, through the tax hikes in 1990 and 1993 that when it comes to taxes, a pro-

“Capital gains taxes are closely linked to business start-ups, which translate into freedom and independence for women.”

mise made is a promise broken. And when they feel this way, they express it by sales tax avoidance, by IRS rage, and, principally and most important, by not showing up at the polls or thinking politics isn't for them. I argue that our low voter participation is in large part the expression of a massive and stubborn tax discontent.

In conclusion, I think we can go back to Thomas Paine for guidance. In the same book where he first gave us the image of the greedy hand, *The Rights of Man,* Paine wrote of how that hand might be vanquished. "People merely needed the political will to change," he wrote. "If systems of government can be introduced less expensive and more productive of general happiness than those which have existed, all attempts to oppose their progress will in the end be fruitless."

Jennifer Dunn: The entire U.S. Congress finally agrees that there should be tax relief. Now, when has that ever happened before? Certainly not in my six years of serving in Congress. When I first got elected in 1992, I wanted to do something about regulation and our huge, overpowering, overzealous, overinvasive federal government. And I wanted to get taxes down because when you cut taxes you're really doing two things: you're leaving the money in people's pockets and you're taking the money away from government, which will surely spend it.

So for the first time in ages, I have seen the list of agenda items for the Senate and for the House overlap on four categories: on education, on Social Security reform, on national defense, and on tax relief. Unfortunately, tax relief may be sixth, seventh, eighth on the list of the public's desires about what to do with the surplus or government spending in general. But tax relief is being constantly talked about. It is part of the vocabulary these days. There is not a member of the House or the Senate who has stood up, within my hearing, and said, "We refuse to give tax cuts to people."

The debate is between targeted tax provisions and across-the-board proposals, which I talked about in the State of the Union response: 10 percent across the board, no means testing, and moving the 15 percent bracket up.

There are several important issues that Congress must address in this session, and I'd like to comment on some of them briefly. IRS reform is one. That has a huge impact on the number of dollars that are spent by government. Last year, we put in charge of the IRS a private-sector oversight board that will preclude the IRS from spending another $4.5 billion on putting in a computer system that never did produce the information the agency needs on the income it brings in.

Another issue Congress needs to address is the marriage penalty. Right now, when a couple marries and the second earner, usually the wife, starts paying taxes at the highest marginal rate of their combined income, that's about a $1,400 per year increase over the total of what they paid separately. We need to change that.

Social Security is another key issue. A woman who is in the workforce her whole life, who's putting money through her payroll taxes into the Social Security system, may, at the end of her career, opt to take a portion of her husband's Social Security. She has that opportunity and therefore the dollars that she put in during her working years would have been for nothing. Now, just think of the difference if she could have put those dollars into a personal savings account that would belong to her, that at her death could be willed to a child or to a spouse. That's vitally important.

Women care a lot about taxes these days. Women are starting businesses at twice the rate of men. That is phenomenal. By the year 2000, half the businesses in this nation will be owned by women. This is important because it means that women are interested in benefits for their employees; they're interested in where payroll taxes go, Social Security, Medicare. But taxation affects them even beyond the way it would affect a man starting a business. For example, 84 percent of women use a certain portion, in most cases a large portion, of personal savings to start their businesses. So, capital gains taxes are very important. If a woman got to keep the dollars she would pay the federal government in capital gains taxes, for example, when she sells her house, that money would go into savings. So capital gains taxes are closely linked with business start-ups, which translate into freedom and independence for women. ■

Cato Calendar

Liberty in the New Millennium
New York • Waldorf Astoria • June 2, 1999
Speakers include John Stossel, Roger Ailes, and Edward H. Crane.

Cato University
San Diego • Rancho Bernardo Inn • August 1–7, 1999
Speakers include Nathaniel Branden, Christina Hoff Sommers, Alan Kors, and Edward H. Crane.

The Crisis in Global Interventionism
Washington • Cato Institute • June 10, 1999
Speakers include Deepak Lal, Robert J. Shapiro, Byeong-Ho Gong, William McGurn, and Ian Vásquez.

The Search for Global Monetary Order
17th Annual Monetary Conference
Washington • Cato Institute
October 21, 1999
Speakers include Stanley Fischer, Anna Schwartz, Judy Shelton, George Selgin, and Charles Calomiris.

Third Annual Technology and Society Conference
Cosponsored with *Forbes ASAP*
Santa Clara, California • Biltmore Hotel
November 4–5, 1999

“Central bankers believe that deflation is always harmful, no matter its cause.”

DEFLATION *Continued from page 1*

average breadwinner.

Benign deflation is a relatively unfamiliar concept both because modern economists devote relatively little attention to it (focusing all their discussions on inflation or on deflation of the malignant sort) and because monetary policymakers in the United States and elsewhere have prevented benign deflation from occurring throughout most of the 20th century. Thus, since World War II, the United States has witnessed frequent gains in productivity. The real (inflation-adjusted) unit cost of production of goods and services today is approximately half of what it was in 1945. Yet the general price level, instead of being half as high as it was after the war, has increased to over nine times its former level. Instead of allowing goods' prices to fall along with their falling real costs of production, the Fed has artificially inflated those prices by pumping large amounts of money into the economy. The last time productivity improvements were allowed to be reflected, partially and temporarily, in a *fallen* price level was in 1955, 44 years ago. And that was not by design but by accident.

Yet ongoing, benign deflation is not just a hypothetical possibility. Many Western nations experienced something like it between 1873 and 1896, when the gold standard placed limits on Western governments' ability to offset the effects of productivity improvements through monetary expansion. Although national price levels declined almost continuously from 1873 to 1896, causing scholars for a time to refer to the era in question as the world's first "Great Depression," every other economic indicator—prices, wages, profits, industrial output, trade—shows the period to have been one of unprecedented growth and prosperity. The period had its share of genuine depressions, to be sure, but those cyclical downturns were a result of faulty financial legislation. No harm seems to have come from allowing a downward trend in prices so long as that trend reflected ongoing gains in productivity.

The last decade or so has witnessed substantial gains in labor productivity, along with smaller gains in total factor productivity, making the present era one in which significant reductions in the nominal cost of living might have been painlessly achieved. The world's central bankers have, however, been unwilling to let those reductions occur.

Central Bankers' Misconceptions

Central bankers believe that deflation is always harmful, no matter its cause. They are convinced (1) that deflation is unfair to debtors, because it arbitrarily increases the real value of their debts; (2) that deflation means falling wage rates and increased unemployment; (3) that a stable, or slowly rising, price level is the best means of avoiding booms and busts; (4) that deflation may mean artificially high real interest rates, because nominal interest rates can never go below zero; (5) that deflation is painful to sellers, who will therefore resist cutting prices; and (6) that a variable rate of deflation must be a source of avoidable entrepreneurial confusion and error. In truth, none of those beliefs is valid so long as the deflation in question mirrors the economy's rate of productivity growth.

Consider first deflation's effects on debtors. Suppose that over the course of one year overall productivity unexpectedly rises 2 percent and the general price level declines 2 percent. Then, although creditors will earn a higher real interest rate than they anticipated, debtors will have no reason to complain: although the real value of debtors' obligations rises, so does their real income, while the *nominal* payments burden borne by them is unchanged. Debtors can, in other words, afford to pay higher real rates of interest, and might well have agreed to such rates in advance had they and their creditors both been equipped with perfect foresight. A monetary policy aimed at deliberately preventing prices from falling would, in this case, merely deprive creditors (and other people with fixed incomes, including persons living on Social Security) of their fair share of productivity gains being enjoyed by all other income earners.

Those who insist nevertheless upon a policy of price-level stabilization as the only equitable policy would do well to consider what such a policy entails in the event of a *setback* to productivity. When productivity declines, the only way to keep the price level stable is by *shrinking* nominal incomes. Debtors might then find it not only difficult but perhaps impossible to repay their loans. If it is admitted that debtors' and creditors' interests are best served by an increase in prices when productivity declines, then symmetrical reasoning suggests that those same interests are best served by allowing

Tom G. Palmer, Cato's director of special projects and director of Cato University, lectured on property rights at Cato's Eleventh Annual Benefactor Summit.

> **"Productivity-driven deflation is good news to the average breadwinner."**

prices to fall as productivity advances.

The falsity of the belief that deflation must involve falling wages has already been alluded to. When productivity rises, so do workers' *real* wages. In other words, nominal (money) wage rates rise relative to the cost of living. If the productivity gains are allowed to take the form of falling output prices, then money wage rates will remain stable or will rise modestly. (The second result obtains if prices fall at a rate equal to the growth rate of total factor productivity, which usually progresses more slowly than the growth rate of labor productivity.) Otherwise, if the monetary authorities insist on preventing the price level from falling, productivity gains must take the form of more rapidly increasing money wages.

Suppose, for example, that labor productivity grows at an annual rate of 3 percent, while total factor productivity grows at an annual rate of 2 percent. Then the real wage rate, which reflects labor productivity, should also increase at an annual rate of 3 percent. If consumer prices are allowed to decline at a rate equal to the rate of growth of total factor productivity, money wage rates will still increase at a modest 1 percent annual rate. If, in contrast, the authorities insist on stabilizing the CPI, money wage rates must increase 3 percent a year. Generally speaking, money wage rates are less "flexible" than output prices, so a policy of avoiding or limiting wage-rate adjustments by allowing prices to fall is less likely to be a source of labor-market "frictions" and consequent labor misallocation. (Of course, if productivity *declines,* labor-market disturbances are best avoided by letting output prices rise while leaving money wage rates alone, rather than by stabilizing output prices and thereby making a *reduction* in money wage rates necessary.)

The relative rigidity of input prices, and of the price of labor especially, compared to output prices is also reason for doubting the widespread belief that a stable price level best avoids booms and busts. Suppose, for example, that productivity grows more rapidly than usual. In that case, a zero-inflation policy requires a money growth rate sufficient to sustain a rate of factor-price inflation equal to the rate of productivity growth. If, however, factor prices are rigid, more rapid monetary expansion may at first succeed in swelling corporate earnings, without inducing any equivalent rise in factor prices. Firms' profits will then be artificially enhanced. Speculators who fail to appreciate the temporary nature of those swollen profits will bid up stock prices, generating a boom. Eventually, though, factor prices will respond positively to expanded earnings (costs will catch up with revenues), so profits will shrink, and share values will decline. The boom will give way to a bust. Were the monetary authorities to stabilize, not the level of output prices, but the level of *input* prices (or, equivalently, the flow of nominal income or revenues), the boom-bust cycle might be avoided.

The claim that deflation is painful to sellers, so they resist cutting prices, may be valid for malign, demand-driven deflation, but it is not valid for deflation of the benign, productivity-driven sort. When overall spending on goods and services shrinks, sellers may resist cutting prices until they can negotiate corresponding cuts in costs, thereby preserving their profit margins. For that reason, product prices are often set according to "implicit contracts" promising some fixed percentage markup of prices above unit costs. But this practice, which accounts for the sluggish adjustment of product prices in response to changes in consumer spending, does not lead to sluggish price adjustment in response to changes in productivity. When productivity changes, so do unit costs of production, so adjustments in product prices are in fact required to preserve constant markups. Indeed, sellers actively seek ways to improve productivity just so that they can charge less than their rivals without sacrificing profits. Productivity-based price cuts are, in other words, a healthy aspect of the competitive process, which would occur routinely in most markets were it not for monetary authorities' success in offsetting productivity gains with equal or greater additions to the flow of nominal expenditures.

The fear that deflation may mean artificially high interest rates, because nominal interest rates cannot be negative, is a red herring so long as the rate of deflation is never allowed to exceed the rate of productivity growth. Suppose, for example, that the nominal interest rate in an economy with constant total factor productivity and a constant price level is 4 percent. If monetary policy were to tighten to the point of causing a 5 percent annual rate of deflation, with no offsetting improvement in productivity, disorder would result: nominal interest rates would approach, but could not fall below, zero, despite the deflation, creating a surplus of loanable funds and a correspondingly deficient level of current spending. But suppose that deflation is only allowed to proceed so long as it is matched by corresponding productivity gains. In that case, a 5 percent annual rate of deflation would only be permitted in response to a 5 percent growth rate in total factor productivity. Such a high rate of productivity growth tends to be reflected in a correspondingly high equilibrium real rate of interest. The effects of productivity growth and of deflation on the *nominal* interest rate would then tend to offset one another. In other words, equilibrium nominal interest rates would almost certainly remain positive.

Does Deflation Confuse Entrepreneurs?

The last mistaken belief—that a stable price level best serves to avoid entrepreneurial confusion and error—arises from a failure to appreciate the fact that incorrect price-level forecasts are only one of several kinds of forecast errors that can frustrate entrepreneurship. Of course a stable and, hence, fully predictable price level is desirable in a world of unchanging productivity, because price-level fluctuations could never be a source of useful entrepreneurial information in such a world. But ours is a world in which productivity constantly changes, sometimes for better, sometimes for worse. In our world, unexpected productivity-driven price-level movements would serve to inform entrepreneurs of underlying changes in economic efficiency in the most transparent possible manner. If the price level is allowed to vary only with opposite changes in productivity, entrepreneurs' inability to forecast every change in the price level is merely a reflection of the general impossibility of accurately forecasting productivity changes. Monetary authorities who imagine that they can avoid this source of entrepreneurial error by stabilizing output prices are deluding themselves: by stabilizing output prices, they mere-

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"Overall unit costs of production in the private sector have declined. Why shouldn't the general price level be allowed to reflect this fact?"

DEFLATION *Continued from page 12*

ly succeed in destabilizing factor prices and nominal income, adding to instead of minimizing entrepreneurial confusion.

Probably all central bankers appreciate the importance of allowing particular money prices to reflect changing cost conditions in particular industries. Everyone understands that computers are being produced more efficiently today than they were a decade ago. That this information is most readily conveyed to consumers and entrepreneurs through a lower price tag on computers seems obvious. Yet central bankers refuse to extend this logic to cover *general* changes in productivity. In reality, not only computers, but also most other goods and services, are being produced at lower real cost (that is, with less land, labor, and capital per unit) today than was the case a decade ago. Between 1991 and 1997, overall unit costs of production in the private sector declined at an average annual rate of just over eight-tenths of 1 percent. So why shouldn't the general price level be allowed to decline so as to reflect this fact? The answer is, for no reason at all, save central bankers' unwarranted belief that deflation—even a little deflation—can never be in consumers' best interest.

Productivity growth continues to put downward pressure on prices, and would result in actual deflation if only the Fed and other central banks would allow it. Instead of aiming at zero inflation or (even worse) allowing prices to continue their gradual, upward drift, the world's central bankers should allow price-level movements reflecting opposite changes in productivity. They can do this by stabilizing, not consumers' prices, but the growth rate of nominal spending, allowing such spending to grow at a rate equal to the (expected) long-run growth rate of labor and capital, or (to judge from statistics for the last decade) at an annual rate of about 2 percent. This policy would lead to a very gradual downward trend in national price levels, interrupted by occasional productivity setbacks or "supply shocks," like the OPEC-sponsored oil shortages of the 1970s. Because the policy requires that central banks always create enough money to offset hoarding (as reflected in reductions in money's "velocity of circulation"), it poses no danger of a recurrence of a 1930s-style depression. Only benign deflation would be allowed: every decline in prices would be good news to both consumers and businesspeople.

The Ghost of the Great Depression

If the policy of mild, benign deflation being recommended here seems extreme, it is only because people have long been accustomed to rising prices, because of the lingering ghost of the Phillips curve (which purports to show a negative relationship between the rate of inflation and the rate of unemployment), and because the Great Depression gave deflation a bad reputation from which it has yet to recover. In this connection, it is worth noting how, prior to that episode, many of the world's most famous economists, including Alfred Marshall, Dennis Robertson, Gunnar Myrdal, and Friedrich Hayek, viewed gradual deflation geared to productivity improvements as the least disruptive way to pass the benefits of economic progress along to consumers, including persons living on fixed money incomes. Their reasoning agreed with what used to be common sense: as goods become less costly to produce, their prices ought to fall.

The Great Depression dealt a near-fatal blow to such common-sense thinking about prices and the price level. A new generation of economists became so obsessed with avoiding the bad kind of deflation that they all but forgot about the good kind. Followers of Keynes advocated inflationary policies, which have been the norm ever since. Having paid penance for the Great Depression by suffering through six decades of inflation, it is time for us to revive old-fashioned logic concerning the potential benefits of deflation.

Recognition of the possibility of benign deflation should have a salutary effect on the thinking of the world's central bankers. By helping them to overcome their fear of falling prices, it will encourage them to deal a deathblow to the worldwide scourge of inflation. But that is only the beginning. Once the possibility of benign deflation is fully appreciated, zero inflation itself will come to be recognized as an overly expansionary policy—that is, as a mere steppingstone on the way to something even better. ■

STUDIES *Continued from page 3*

dramatically by the end of the Cold War, but "U.S. foreign policy remains on autopilot." In assessing purported threats to U.S. security, Eland, Cato's director of defense policy studies, notes that "most of the Pentagon's military planning covers areas of the world that are not very critical to U.S. vital interests, which, contrary to conventional wisdom, indicates how few threats currently exist." With the demise of the Soviet Union, hawks proposing increased defense spending must scour the globe for enemies. "Given the lack of a credible threat from any specific country, people who desperately search for enemies—that is, advocates of foreign intervention and a large defense budget—must settle on the vague notion of 'instability,'" Eland notes. But he adds that "instability in most parts of the world is rarely a threat to the United States," and the number of conflicts per year has actually declined by more than half since 1992. "Intervening anywhere and everywhere to battle instability when it doesn't adversely affect U.S. vital interests could merely motivate rogue states or terrorist groups to attack the American homeland with nuclear, biological, or chemical weapons," he contends.

◆Missile Defense System Needed to Deter Rogue States

A new Cato study says that the greatest threat to the United States in the post–Cold War world comes from the five rogue states of Iran, Iraq, Libya, Syria, and North Korea, all noted sponsors of international terrorism. "Disreputable regimes around the world have been steadily advancing their efforts to obtain the technical know-how and components to threaten their neighbors," and ultimately the United States, with ballistic missiles, contend Timothy M. Beard, a former research assistant at the Cato Institute, and Ivan Eland, director of defense policy studies at Cato. In "Ballistic Missile Proliferation: Does the Clinton Administration Understand the Threat?" (Foreign Policy Briefing no. 51), the authors recommend that the United States respond with development and deployment of a national missile defense system, which "should proceed at a measured pace." Beard and Eland offer a country-by-country review of the

"It is imperative that the regulatory system that has governed banking with little change since the 1930s be modernized."

threats posed by the rogue states. They find that "each of those nations has made a diligent attempt to acquire ballistic missiles and some sort of WMD [weapons of mass destruction] capability either through an indigenous development program or by purchasing the technologies on the open market." Although the authors recommend development and deployment of a limited national missile defense system, it should be done "at a pace that the technology can support and that test results will bear out. No matter what the threat is, rushing to develop a system that fails to work is not an attractive remedy."

◆Betting on the Internet

Attempts by various levels of government to ban Internet gambling are destined to fail, writes Tom W. Bell in a new Cato study, "Internet Gambling: Popular, Inexorable, and (Eventually) Legal" (Policy Analysis no. 336). "The architecture of the Internet makes prohibition of on-line gambling easy to evade and impossible to enforce." The result, Bell says, is that "attempts to outlaw Internet gambling will inevitably fail." As Bell points out, Americans are unlikely to give up gambling. At least 56 percent of Americans gambled in 1995, wagering some $600 billion, of which $100 billion was on illegal sports gambling. "Outlawing Internet gaming services domestically will simply push the business overseas." Countries such as Australia, New Zealand, and Costa Rica have legalized and licensed Internet gaming services. Bell also points out that Americans, including Founding Fathers such as George Washington, Thomas Jefferson, Benjamin Franklin, and John Hancock, have long gambled. Lotteries, Bell writes, "even helped to pay for the first home of the U.S. Congress, as well as for public buildings throughout the new U.S. capital." Bell concludes that legalizing Internet gambling "will reaffirm the values, so dear to the Founders, of individual liberty, property rights, and the pursuit of happiness. And it will establish the Internet as a bona fide technology of freedom."

◆Risk Mismanagement

Why do people respond to risks differently than the experts often predict they will? In a new Cato study, "Cars, Cholera, and Cows: The Management of Risk and Uncertainty" (Policy Analysis no. 335), British scientist John Adams says that risk experts fail to see that people view risk through a "cultural filter." Adams describes three kinds of risks that experts fail to distinguish among: (1) directly perceptible risks, such as those of climbing a tree, riding a bicycle, or driving a car; (2) risks that we understand through the application of science, such as those of cholera and other infectious diseases; and (3) virtual risks, about which scientists either do not or cannot agree (e.g., global warming and numerous suspected carcinogens). The failure to distinguish among the risks and recognize that people view risks differently leads to failed risk assessment. "Professional attempts to manage risks are thwarted by people who insist on being their own risk managers."

◆Examining Missile Defense Options

The debate over developing a national missile defense (NMD) has frequently resembled a theological debate. A new Cato study analyzes and evaluates actual options for deploying an NMD. In "National Missile Defense: Examining the Options" (Policy Analysis no. 337), Charles V. Peña and Barbara Conry contend that "a limited NMD, which would afford the United States protection against long-range ballistic missile threats from rogue states, is feasible and probably can be deployed at a reasonable cost." Peña, an independent consultant on missile defense, and Conry, an associate policy analyst at the Cato Institute, do warn, however, that "the development of an NMD system should proceed at a measured pace because an excessively rapid development program could waste taxpayer dollars on an ineffective system." Peña and Conry note that perhaps the biggest obstacle to NMD is the Anti-Ballistic Missile Treaty. "In the final analysis, U.S. leaders should not permit the ABM treaty to be an insurmountable obstacle to NMD, if such a system can be shown to be in the best interest of U.S. security and to be cost-effective." Peña and Conry examine the missile threat from rogue states, limitations of NMD, and the various NMD options: ground based, layered (ground and space based), sea based. "The debate should not be about whether or not to build missile defenses," Peña and Conry conclude. Instead, "the debate should be about the nature and capabilities of a limited NMD system that will accomplish the mission of protecting the nation against threats from rogue states, and do it cost-effectively."

◆Bank Regulation Reform Long Overdue

The time has come to reform antiquated federal laws to permit "commercial banks to engage in a wide variety of financial services and to permit other financial services firms to engage in commercial banking," writes University of Chicago professor Randall S. Kroszner in a new Cato study. In "Bank Regulation: Will Regulators Catch Up with the Market?" (Briefing Paper no. 45), Kroszner argues that "it is imperative that the regulatory system that has governed banking with little change since the 1930s be modernized." Repeated congressional attempts at fundamental reform in each of the past dozen years have failed, Kroszner notes. As the proposed merger between Citibank and the Travelers Group reveals, "the markets simply cannot wait any longer for legislative reform and are taking deregulation into their own hands." Kroszner also argues for the repeal of the Glass-Steagall Act of 1933 and suggests that no new obstacles to the consolidation and rationalization of the financial services industry should be imposed. Today's investors "would not be harmed by an end to Glass-Steagall and could benefit from the convenience of one-stop shopping for financial services."

University of Chicago economist Randy Kroszner discussed banking regulation at Cato's 1998 monetary conference and in a new Cato paper.

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"Rather than help to dissipate the legacies of communism, U.S. economic aid (to Russia) has reinforced central planning and political control over economic decisions."

STUDIES *Continued from page 13*

◆Benefits of Kyoto Not Worth the Costs

The models predicting the cost of implementing the Kyoto Protocol should be "discounted," says Peter VanDoren, the editor of *Regulation* magazine, in a new Cato study. Because the various economic models predicting the cost of the treaty use different assumptions about the way in which electricity will be generated in the United States, their conclusions are bound to vary, VanDoren writes in "The Costs of Reducing Carbon Emissions: An Examination of Administration Forecasts" (Briefing Paper no. 44). "If past experience is any guide, the predictions should be discounted. The use of large-scale models to predict the future costs of policy options does not have a very good track record," he says. Regardless of which model is correct, VanDoren writes, the benefits are not worth the costs. "The almost totally symbolic benefits of the Kyoto Protocol are not worth the real costs it would create," concludes VanDoren.

◆Build One New Fighter, Not Three

The Pentagon should cancel two of its fighter aircraft programs (the F-18E/F and the F-22) and concentrate its efforts on the more futuristic Joint Strike Fighter (JSF), argues Williamson Murray in "Hard Choices: Fighter Procurement in the Next Century" (Policy Analysis no. 334). Murray, professor emeritus at Ohio State University, says that the expensive programs (more than $300 billion) cannot be justified in light of the reduced post–Cold War threat environment. "In the current budgetary environment, there are no easy choices among weapons systems." But trying to avoid hard choices among fighter programs, "may well have a disastrous impact on the ability of the United States to defend its vital interests in the next century." Murray contends that a realistic assessment of the threat the United States will face over the next few decades is missing. "A real peer competitor seems a remote possibility for at least the next three decades and perhaps for as long as half a century. It is unlikely that any enemies that U.S. forces might confront will challenge the United States directly for control of the air."

◆Unilateral Dollarization for Argentina

Argentina should dollarize its economy—replacing the peso with the dollar—write Steve H. Hanke and Kurt Schuler in a new Cato Foreign Policy Briefing paper. In "A Dollarization Blueprint for Argentina" (Foreign Policy Briefing Paper no. 52), the authors contend that dollarizing the economy would ensure that the currency Argentina uses is stable and convertible and would lead to lower interest rates and higher growth rates. "Argentina is already dollarized in an unofficial or even semiofficial sense. Dollar deposits in Argentine banks exceed peso deposits, loans can be made in dollars, and it is legal to use the dollar alongside the peso." Although dollarization could be done through a formal treaty with the United States, that is not necessary. "Our own preference is for unilateral dollarization, now rather than later," write Hanke, professor of applied economics at Johns Hopkins University, and Schuler, a senior economist at the Joint Economic Committee of the U.S. Congress. "The sooner the government eliminates the lingering uncertainty in the currency board–like system, the sooner interest rates can fall and the sooner Argentina's economy would benefit."

Steve H. Hanke discusses Latin American monetary policy at a Cato Policy Forum.

◆Administrative Costs of Social Security Privatization

The latest criticism of privatized Social Security is that the administrative costs will be too high. In "Administration Costs and the Relative Efficiency of Public and Private Social Security Systems" (Social Security Paper no. 15), Robert Genetski says that under a privatized Social Security system, "administrative and money management expenses for a system of individual accounts could amount to roughly $35–$55 per worker for the first year," a cost that is "slightly higher than that of the current government-run Social Security program." However, Genetski notes, in exchange for slightly greater administrative costs, "workers in a privatized system would receive a greater rate of return on their investment and better and more secure retirement benefits." Genetski, senior managing director of Chicago Capital, Inc., and former chief economist at Chicago's Harris Bank, cautions that administrative costs will be influenced significantly by the way the new system is set up. To minimize those costs, he says, Congress should avoid limiting the size of accounts by moving to partial rather than full privatization and not pile on extensive new reporting requirements or other rules that would push up costs.

◆Aid to Russia Ineffective

U.S. aid to promote market reforms in Russia and Central and Eastern European countries since the collapse of the Soviet Union has been largely ineffective, writes Janine R. Wedel in a new Cato study, "Foreign Aid Failures in Russia and the Former Soviet Bloc: U.S. Aid Doesn't Produce Market Reforms" (Policy Analysis no. 338). Wedel argues that "rather than help to dissipate the legacies of communism, U.S. economic aid has in some cases instead reinforced the legacies of suspicion, central planning, and political control over economic decisions." She provides a detailed examination of the role played by U.S.-based consultants who were dispatched to help promote privatization and market reform. She argues that aid often goes to Western consultants whose advice is redundant or useless. For example, in Eastern Europe, "The majority of the consultants were 'fly-in, fly-out' advisers who visited the region for a short time, developed weak links with recipients, and knew little of the countries they were trying to help." Wedel concludes that in Central and Eastern Europe, "aid has generated some cushy jobs for Western consultants but, in terms of development, has added little to what private, voluntary exchange could provide on its own." ■

Public understanding more important than theoretical models

Economists Should Talk to the Public

It has been said that if all economists were laid end to end they would not reach a conclusion. In a new Cato Institute book edited by Daniel B. Klein, nine of this century's greatest economists do agree on one thing: economic research must be firmly rooted in public issues and contribute to better understanding of economic concepts by public officials and voters.

Klein, associate professor of economics at Santa Clara University, gathered essays from Friedrich Hayek, Ronald Coase, Thomas Schelling, Gordon Tullock, Israel Kirzner, Frank Graham, William Hutt, Clarence Philbrook, and Deirdre McCloskey addressing the essential issue for economists: How do we contribute to human betterment?

Klein calls on economists to use their expertise to help make a better society, not just to pursue technical precision. He and the authors point out that there are major differences between political economy and such disciplines as physics, chemistry, engineering, and medicine. Practitioners in the latter fields are experts appointed to make important decisions. "But the actual decisions of political economy are made, not by experts, but by ordinary public officials and voters—the 'Everyman,'" Klein writes. "The practitioner of political economy is typically highly ignorant of basic economic ideas."

One result, Hayek writes, "is that in economics you can never establish a truth once and for all but have always to convince every generation anew." Consequently, in this field, Hayek concludes, "almost more than any other, human folly displays itself."

Klein raises a series of key issues addressed in the essays, including, How can economists influence public affairs? Should economists remain principled although it may hurt their careers? How much should economists attempt to mold society? For the most part, the authors encourage economists to become more engaged in public discourse, although they do disagree, naturally, on which specific ideas and solutions should be stressed.

Nobel laureate James M. Buchanan of George Mason University says the book "raises provocative questions that should make all economists think. What is our *raison d'être?*"

What Do Economists Contribute? can be ordered in cloth ($50.00) or paper ($17.50) by calling Cato Institute Books at 1-800-767-1241. ■

Center for Constitutional Studies

First brief charges Congress has exceeded constitutional powers

Cato Launches Amicus Curiae Project

In an effort to remind the Supreme Court that government has delegated, enumerated, and limited powers, the Center for Constitutional Studies at the Cato Institute under the direction of Roger Pilon has launched a new project. The Cato Institute recently filed its first-ever amicus curiae (friend of the court) brief, urging the Supreme Court to find the Domestic Violence Clause of the Violence Against Women Act (VAWA) unconstitutional.

Citing the 1995 decision *Lopez v. United States,* the brief argued that "only commercial activities are subject to Congress's authority under the Commerce Clause" and that the Domestic Violence Clause does not regulate commercial activity. The Court later refused to hear the case.

The amicus brief, submitted by Timothy Lynch, associate director of the center, and Jarett Decker, an attorney and Cato adjunct scholar, asked the Supreme Court to overrule the Second Circuit Court of Appeals in the case of *Rita Gluzman v. United States.*

"If allowed to stand, the Second Circuit's ruling [upholding VAWA] will undermine the local control and accountability that the Framers intended for the dangerous powers of law enforcement, and will threaten individual rights by permitting federal authorities to circumvent the rights of citizens under their own states' laws, while also eviscerating the doctrine of enumerated powers—liberty's first line of defense against an overweening central government," the brief argues.

The central holding in the *Lopez* case, the brief pointed out, was that "Congress's power under the Commerce Clause must at least be restricted to commercial activity." Thus, in a decision written by Chief Justice Rehnquist, the Court struck down the Gun-Free School Zones Act because it was "a criminal statute that by its terms has nothing to do with 'commerce' or any sort of economic enterprise, however broadly one might define those terms." The Cato brief argued that *Gluzman* involved the same thing: a criminal statute having nothing to do with commerce.

The brief also stated that passage of the Domestic Violence Clause reflects "a trend in which Congress has been duplicating state offenses in the federal criminal code, particularly on 'hot-button' issues suitable for political posturing. That expansion of federal authority into areas the Framers never intended undermines many aspects of the constitutional structure they designed, throwing the system out of balance in ways that threaten individual rights and liberty." The Commerce Clause "should not be stretched beyond its bounds—as the Second Circuit has stretched it—to swallow up traditional areas of state authority such as domestic abuse." ■

◆If only we could trust you

"We could give it all back to you and hope you spend it right," [President] Clinton said of the budget surplus.

—*Washington Post,* Jan. 21, 1999

◆Who's oppressed?

The number of Cubans and Haitians caught after landing on Florida beaches has risen dramatically over the past four months. . . .

"No one is leaving because they are oppressed people. They are leaving because of the economic opportunities in the United States," said [Michael] Nicley [deputy chief of the U.S. Border Patrol].

—*Washington Post,* Feb. 10, 1999

◆At least contract rights are respected somewhere

Cuba made good early today on its threat to suspend most telephone links with the United States in retaliation for the withholding by five American telecommunications firms of $19 million in payments owed to the state-controlled phone company [in Havana]. . . .

Today's edition of Granma, the official newspaper of Cuba's Communist Party, justified the disruption of service by saying that the American phone companies had brazenly violated an agreement with their Cuban counterparts.

—*Washington Post,* Feb. 26, 1999

◆Economic growth defined

For rural Pulaski County [Virginia], it was like a dream come true: Volvo . . . decided last year to expand its truckmaking plant here. . . .

But the owners of other businesses worry that the Volvo expansion could hurt them by luring away their best workers. . . .

"I'm sure they'll take people from us," said David B. Spangler, president and chief executive of Jefferson Mills, a textile plant that employs 320 people in the town of Pulaski. "They already have, and they'll take my younger and better people. Anybody they take will start earning twice as much as we pay after we've trained them."

—*New York Times,* Mar. 13, 1999

◆Or maybe they have no choice

Lorna Waugh, president of the Community School District 29 parents council, representing southeast Queens, said there was a wide range of opinion about vouchers. . . .

Ms. Waugh said she was not sure whether there was a consensus, pro or con, about vouchers but noted that many people had already made the decision about public versus private.

"We have 25,000 children [in the public schools], and there is no mass exodus," she said. "I would assume they are satisfied, don't know better or don't care."

—*New York Times,* Mar. 13, 1999

◆And it's not like you could expect us to do anything about them locally

"Was [impeachment] really worth the time and effort, for something clearly partisan, for something that clearly did not have the public's support? Why was it done?

"Meanwhile, our schools, our neighborhoods, all the other issues were just put on hold for a year. It leaves you angry."

—Marc Morial, Mayor of New Orleans, in the *New York Times,* Feb. 14, 1999

◆Another such deal and we'll all be working *two* jobs

Rep. Sherrod Brown (D., Ohio), a staunch opponent of trade liberalization, jumped on the trade-deficit issue. "We must not allow China's membership in the World Trade Organization," he said. "These sweetheart trade deals will only further swell the trade deficit and eliminate more American jobs."

The U.S. employment rate, at 4.4%, is still hovering around 28-year lows.

—*Wall Street Journal,* Mar. 19, 1999

◆But as long as we don't have term limits . . .

"Like most new members I plan to rent for a while," said [Rep. John] Larson. . . . "But if your seat in Congress is relatively safe, it may make sense to buy a place [in Washington]."

—*Washington Post,* Jan. 9, 1999

◆Get those people back on welfare

The nation's food stamp rolls have dropped by one-third in four years, leading to a growing concern that the decline is caused partly by needy people's hesitance to apply for benefits.

Federal officials had been particularly concerned with the situation in New York, where newly revamped welfare offices, now called job centers, were delaying food stamp applications and often directing applicants to private food pantries instead.

—*New York Times,* Feb. 25, 1999

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1000 Massachusetts Ave., N.W.
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