Jude Wanniski

A SUPPLY-SIDE FOREIGN POLICY

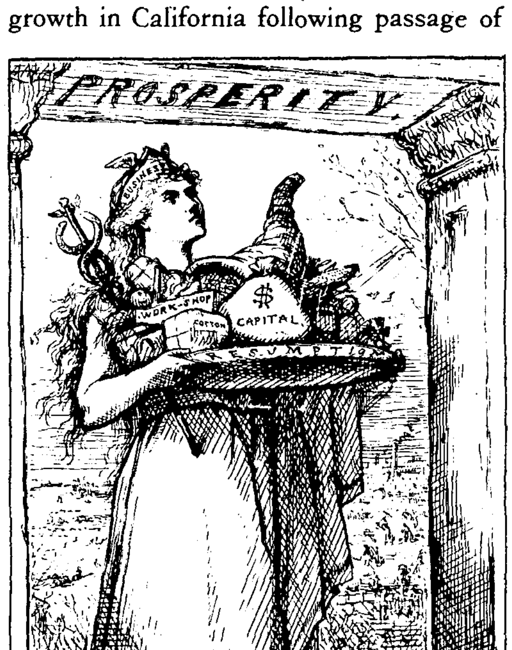
Bringing classical economic reforms to rampant global inflation.

The "fundamental principles" of taxation, as he called them, were laid out by Treasury Secretary Andrew Mellon in a 1924 statement. It is a classic as well as a classical statement, one that now lies at the heart of domestic "Reaganomics." Mellon said, in part:

> The problem of the Government is to fix rates which will bring in a maximum amount of revenue to the Treasury and at the same time bear not too heavily on the taxpayer or on business enterprises. A sound tax policy must take into consideration three factors. It must produce sufficient revenue for the Government; it must lessen, so far as possible, the burden of taxation on those least able to bear it; and it must also remove those influences which might retard the continued steady development of business and industry on which, in the last analysis, so much of our prosperity depends. Furthermore, a permanent tax system should be designed not merely for one or two years nor for the effect it may have on any given class of taxpayers, but should be worked out with regard to conditions over a long period and with a view to its ultimate effect on the prosperity of the country as a whole. . . .
>
> I have never viewed taxation as a means of rewarding one class of taxpayers or punishing another. If such a point of view ever controls our public policy, the traditions of freedom, justice and equality of opportunity, which are the distinguishing characteristics of our American civilization, will have disappeared and in their place we shall have class legislation with all its attendant evils. The man who seeks to perpetuate prejudice and class hatred is doing America an ill service. In attempting to promote or defeat legislation by arraying one class of taxpayers against another, he shows a complete misconception of those principles of equality on which the country was founded. Any man of energy and initative in this country can get what he wants out of life. But when that initiative is crippled by legislation or by a tax system which denies him the right to receive a reasonable share of his earnings, then he will no longer exert himself and the country will be deprived of the energy on which its continued greatness depends.

President-elect Reagan essentially campaigned on these principles and has committed himself to them. The size of his victory November 4, along with Republican control of the Senate and expanded influence in the House, point toward domestic tax reforms in 1981 along classical lines. The objective of the supply-siders is a tax bill that ends the distinction between "earned" and "unearned" income, bringing the top rate on saving-and-investment income to 50 percent from 70 percent; the Kemp-Roth reductions would proceed from that level. The maximum tax rate on all income, then, would be 45 percent in 1981, which means the effective rate of tax on capital gains would be roughly 15 percent. Such change would have substantial effects on national productivity, lift the value of financial assets, and provide a solid foundation for domestic economic gains through the Reagan years.

Because the United States is such a large part of the world economy, domestic economic reforms that boost productivity will have beneficial effects around the world—in the same way that economic growth in California following passage of Proposition 13 in 1978 had buoyant effects on the rest of the United States. But the reverse is also true. If the rest of the world economy follows perverse economic principles—moving up the Laffer Curve even as we head down—it will transmit those negative effects to the United States, offsetting our gains and perhaps swamping them. On November 24, for example, Margaret Thatcher provided yet another shock to the U.K. economy by hoisting tax rates on North Sea oil and a variety of consumer goods, thereby decreasing the efficiency of the world economy. The ripple effects were felt immediately in the United States through the financial markets.



For its own success and that of the nation, then, the Reagan administration cannot act as if movement toward correct economic policies at home will be sufficient, perhaps believing that the U.S. *example* will eventually be transmitted globally. After all, if the U.S. economy is swamped by international economic distress in 1981, the *example* itself will be submerged and discredited, here as well as abroad. This is why it is so critical that a new president, at the very outset of his administration, shape a foreign policy that has as a key ingredient the transmission of classical economic reforms to the rest of the world.

The most immediate and pressing threat to the world economy which the Reagan administration must face is the Third World debt to the international banks, a debt that now exceeds $300 billion. On the face of it, there is no prospect that this debt can be repaid, and because the amount exceeds by many, many times the amount of capital in the international banks, these banks would be technically bankrupt were it not for continued currency inflation. Indeed, lacking any other solution, the banks have a profound vested interest in global inflation. It preserves the illusion of solvency even as the debt mushrooms. Where once the international banks were ardent exponents of a gold standard for the dollar, which maintained a reliable unit of account between debtors and creditors, they led the way in the early 1970s in urging a "floating" dollar. Citibank, the biggest of them all, was the most ardent in pushing for an end to the dollar/gold link, but Chase Manhattan and the Bank of America were not far behind. New money to roll over Third World debt could be created through deposits in the Eurodollar market. The inflation brought some relief to debtors, but not for long. It also hurt holders of dollar assets, most particularly the OPEC nations. In an attempt to keep even with inflation, they hiked the dollar price of oil. This only meant new private money creation by the banks was necessary, triggering another round of inflation.

The Third World debt mushrooms for the most part because of compounding finance charges, not because of a net increase in actual imports of resources. Imagine buying a television set in 1955 and paying for it over 30 years and you have a picture of the fix the Third World is in. The TV set (the original development project) has long ago been scrapped, but the finance charges go on and on. As a result of rising interest charges at the end of 1979, Third World debt service obligations rose by $7.5 billion.

The International Monetary Fund, founded in 1945 to deal with international balance-of-payment problems, must not only find a way to pay for the oil that goes to the developing nations, it must also scramble for the funds to refinance existing debt. Countries such as Brazil, which owes $13.6 billion to U.S. banks, are finding they are unable to reduce their debt, which reflects on the low price-earnings multiples of the international banks like Citicorp (which had $4.2 billion staked in Brazil in 1979). If this condition spreads, with countries finding they cannot even meet interest charges because of climbing interest rates, there would of course be a major crisis.

For several decades, U.S. foreign policy has been wagged by this tail of global debt. The IMF and the World Bank are run by and for the money-center banks, the aim being the aversion of international financial collapse and their own bankruptcies. The World Bank's objective is to squeeze the U.S. taxpayer for resources to send to the Third World, with the avowed aim of helping nations develop so their expanding tax bases can support their debt service. The IMF's pattern is to squeeze the taxpayers of the recipient nations, via IMF imposed "austerity plans," to collect the revenues needed to meet international debt obligations. The net result of this one-two punch has been the exact opposite of the intended aim, pushing developing nations up the Laffer Curve and inviting civil strife, revolutions, terrorism, and authoritarian takeovers of one kind or another.

The U.S. State Department and a long string of Secretaries of State have displayed little or no interest in these economic causes of global unrest (Kissinger even boasted of his lack of interest or knowledge of economics). Foreign policy has been a dustpan-and-brush operation, with American diplomats expected to make the best of a worsening situation by playing Metternichian power-bloc politics. The framework for foreign policy is set by the members of the Council on Foreign Relations and, in the 1970s, the Trilateral Commission, who assume, as a given, that the United States is a declining power. And both the CFR and the TLC (founded by Chase's David Rockefeller) are dominated directly or indirectly by the impact of international debt on global commerce. This is quite understandable. The problem is that these eastern elites have the wrong development model.

The development model the United States urged on the rest of the world after 1945 was a modern one, borne of the Great Depression. It focused on the need of governments to get control of "aggregate demand," or consumer demand. If a nation's masses consumed all its production, there would be no surplus, no capital, remaining for investment in "infrastructure." Infrastructure—roads, waterworks, power plants, docks, even a steel industry —was advanced as the key to development, through its ability to increase economic efficiency.

Policy that flowed from this theory took two forms. The poor nations were urged to impose steeply progressive taxes on their people in order to amass revenues to finance infrastructure. Project loans also were made to the poor nations, the loans to be paid back with the tax revenues that would result from economic development. In most cases, the policy financed infrastructure built with material and expertise from the industrial countries. Then and now, development was seen as stemming from physical capital, from "things." The poor nations were left with debt and tax burdens. Entrepreneurial activity was smothered by confiscatory tax rates. And because the infrastructure did not foster growth, tax revenues did not increase. The revenues that were received had to be applied to debt service, while costs of financing general government were taken care of by the printing press and inflation, further discouraging indigenous initiative.

This, of course, was not the developmental path the United States or other industrial nations followed. The classical formula focused on human capital, on "people," not "things." Policy did not focus on consumer demand for things, but on encouragement of individuals to supply their talents and energies to greater production. And if money would hold its value, people would be encouraged to save and invest greater shares of their production—the government would not have to tax it away and invest it for them. In other words, the U.S. economy was built in an environment conducive to individual enterprise: low rates of taxation, minimal central planning, and hard money. Yet this is exactly the model that our modern economic theorists and policymakers discourage the emerging nations from following. It is exactly the model that should now serve as the economic backbone of American foreign policy.

When A.W. Clausen, president of the Bank of America, was nominated last October 31 by President Carter to succeed Robert McNamara as president of the World Bank, the news shocked the supply-side movement. It was, of course, known that McNamara would be ending his 12-year tenure late next spring, which left supply-siders with high hopes for a Reagan-appointed successor who would replace the bankrupt development model with a classical one. And there would be plenty of time for Reagan to ruminate on the choice. President Carter, it was felt, would not dare send up a nomination or the Republicans would howl as wildly as they did in 1968 when President Johnson appointed Abe Fortas to the Supreme Court on the threshold of the elections. The surprise was that Carter would gain Reagan's approval of a "non-political" appointment on the transparently bogus grounds that quick action was necessary to keep the Europeans from snatching the job. The real reason, no doubt, was that the World Bank would try to get another $3.2 billion out of the Congress in the current lame-duck session, that Republicans were not supporting the legislation, and that a Reagan-approved A.W. Clausen might be able to lobby it through. Insofar as they have been part of the IMF-World Bank one-two punch, Clausen and the Bank of America have been part of the problem, with $8.2 billion in debt exposure in the Third World.

The deal was arranged with George Shultz, former Nixon Treasury Secretary, who is now executive vice president of the Bechtel Corp., the leading multi-national packager of Third World infrastructure. Bechtel is virtually an extension, the operating arm of the international banks. Shultz, a member of the Council on Foreign Relations, was the establishmentarian's candidate for Secretary of State until he withdrew his name from consideration. Shultz got close to Reagan this year through Caspar Weinberger, who was Reagan's finance director in the Sacramento days, who followed Shultz as OMB director in the Nixon years, and who until his nomination as Reagan's Secretary of Defense was also an executive at Bechtel. Shultz may not have been acceptable as Secretary of State because he disagrees with Reagan's position in Israel, a not unreasonable posture for a Bechtel executive.

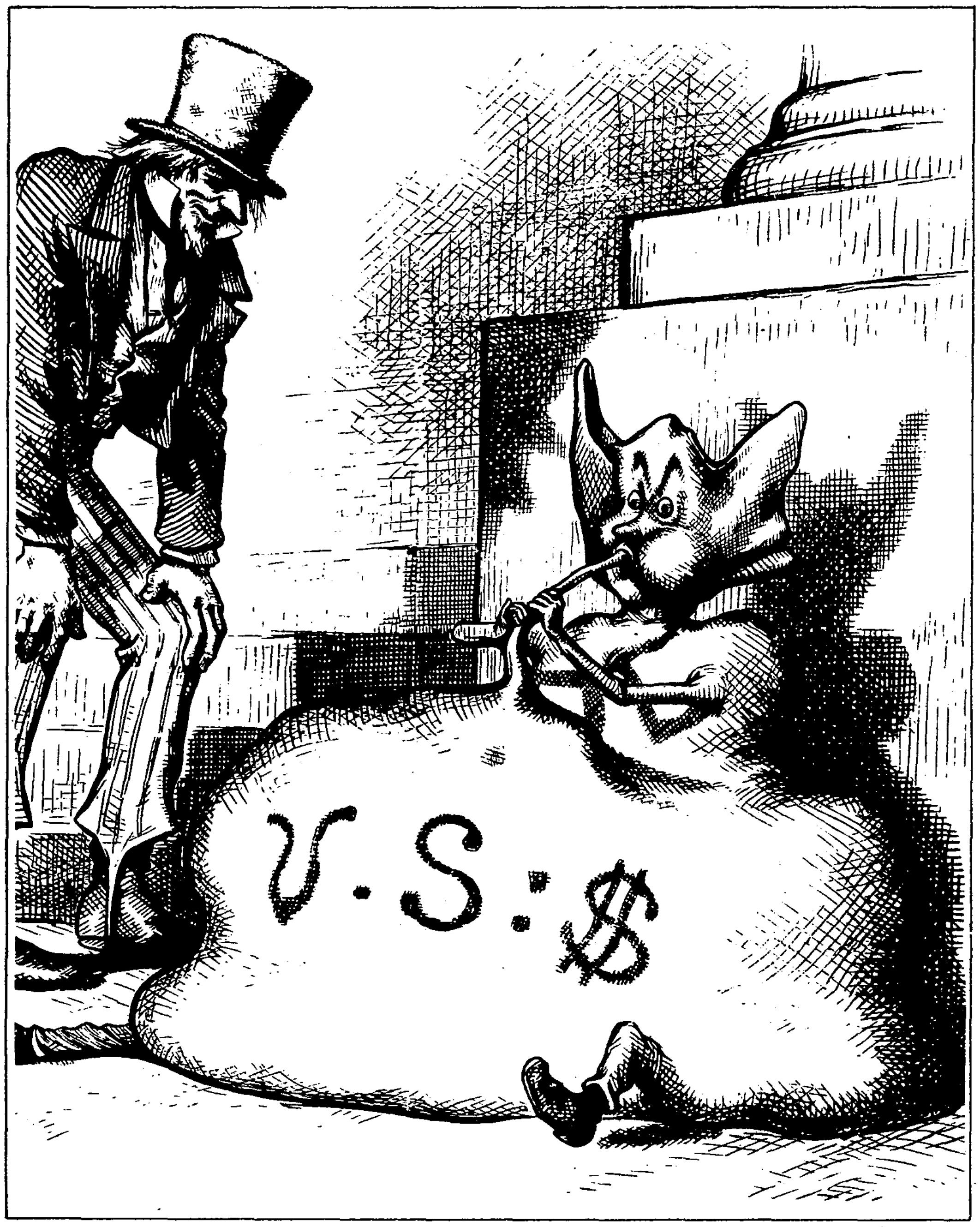
Yet all these interlocking connections in the Eastern Establishment count for something, a distinct way of thinking about the world. When the World Bank request for $3.2 billion surfaced in the lame-duck session, with a push from the lame-duck president, it was backed by Clausen and Shultz. The only reason it stalled was because of the opposition of Richard V. Allen, Reagan's foreign-policy adviser, who said he did not want to commit the President-elect to a major foreign-aid package in advance of his administration. Allen, slated to become Reagan's National Security adviser, was Henry Kissinger's deputy at NSC in 1969 until the two had a falling out, and Allen went on to become deputy to the White House Council on International Economic Policy. Not coincidentally, he now believes that foreign economic policy is the most underdeveloped aspect of U.S. foreign policy. He is, in fact, the pivotal figure in putting economics into the backbone of a Reagan foreign policy. As long as he retains the confidence of Reagan, which seems likely, we can expect his innovative influence to shift the policy framework away from that of the Council on Foreign Relations and Trilateral Commission to pro-growth strategies, which will benefit the international banks in spite of themselves. The key appointment will be the Undersecretary of State for Economic Affairs, a post now held by neo-Keynesian Richard Cooper, formerly of Yale. If it goes to a supply-sider in the Reagan administration, the focus of American foreign policy would shift perceptibly, toward global economic advance and away from Club of Rome assumptions about dwindling resources.

The three pivotal test cases of foreign policy likely will be Jamaica in the Western hemisphere, Turkey in Europe, and Israel in the Middle East. The three are economic basket cases as a result of either systematic doses of IMF austerity schemes, self-inflicted wounds, or a combination of both. Each has had its private, entrepreneurial sector decimated by currency devaluations, savage inflation, and steep tax progressivity, which means they are testing the upper limits of the Laffer Curve. Personal income tax rates in each are on the order of 60 percent encountered at $7,000 to $10,000. Commerce flourishes only in the subterranean economy, which pays no taxes. The new Prime Minister of Jamaica,

Edward P.G. Seaga, told "Face the Nation" on November 24 that he is forced, more than ever, to count on the production and export of marijuana to bolster the economy. "In the last few months in particular," he said, "it has almost been the lifeline economically in providing dollars and foreign exchange which the Bank of Jamaica could not provide." Israel's national fabric is also being shredded by a 125 percent inflation rate and austerity-induced economic stagnation, and successive finance ministers can only think of adding new taxes to curtail "excessive consumer demand" (although Arthur Laffer has been invited to visit the country in January to offer counsel). Turkey, a NATO ally, is in similar, desperate shape after a decade of IMF shoves up the Laffer Curve, and urban terrorism is being held in check, temporarily, by authoritarian rule since the military takeover of last September.

After a decade of rampant global inflation, income tax rates around the world have risen sharply, tax progressions being almost universal outside the Communist bloc. Especially in the Third World, the effect has been the collapse of private commerce beyond the level of cottage industry. Private enterprise cannot compete with public enterprise when returns on private capital are confiscated by taxes that the public enterprise does not face. The citizenry is driven toward public solutions when private solutions are closed off. It would be surprising *not* to find the socialist impulse flowering in the Third World. Where national leadership has ignored or rejected the counsel of the international financial institutions, the opposite has been the result. Tax reform, on the Mellon-Coolidge principle that "high tax rates defeat their own purpose," has brought positive results to Egypt, Chile, and Puerto Rico in recent years. Fidel Castro singled out these nations for special censure at his Havana Third World conference in 1979. He also blasted a China that is shedding the Maoist, gang-of-four goal of *equality of result* (where reward is the same regardless of individual effort) in favor of economic incentives to individual enterprise.

India experimented with sharp cuts in unproductive income tax rates in 1976, with spectacularly successful results, but there was no follow through. Sri Lanka did the same, experiencing a buoyancy in its economy and a spark of private enterprise that endures. Uruguay, at the point of economic and political collapse in the early 1970s, eliminated its income tax entirely—it was producing almost no revenue anyway. It is now flourishing.



Eventually, these kinds of success stories will spread, as one nation after another goes to the brink of revolution. The message could be spread rapidly, though, by a Reagan foreign policy that encourages the IMF and World Bank to alter their development model and galvanizes the foreign diplomatic service to that end. Little resistance would be encountered if the *quid pro quo* for economic assistance is growth rather than austerity, and the seemingly intractable U.S. foreign service might find it attractive to promote populist reforms instead of power-bloc politics.

The international bankers, confounded by the spiraling Third World debt that threatens to engulf them, simply have not been thinking big enough. Worldwide tax reform would free the energies of the people of the Third World in ways that would make it possible for them to eventually pay down their debts. The big banks, though, would not even have to wait that long to get relief. If the savings pool in the West were enlarged, Third World debt would rest more easily on the books. This could be accomplished only by an end to the Western inflation that discourages citizens of the West from contributing to the global savings pool. U.S. monetary reform is the answer here, again along classical lines, moving toward a gold standard with intermediate steps in 1981 that avoid a deflation which the banks justifiably fear would bankrupt them. Admittedly, there is little talk of this in the public prints, and Federal Reserve governor Henry Wallich announces confidently that there is "zero chance" of it, but it is in the wind, as well as in the Republican platform and in the back of the mind of the President-elect.

After a shaky start on foreign policy before the election, Reagan is now doing very well. There was cause for concern when he approved the Clausen deal, during the intense pressure of the campaign. And there was cause for concern when the campaign cut loose Richard Allen, after a flurry of stories in the national press raised questions about his business in consulting to foreign corporations. But Allen is back, secure enough to be able to thwart extension of the World Bank-IMF model into the Reagan years. And after seemingly rushing headlong into a restoration of the Nixon-Ford Cabinet, Reagan decided to take his sweet time to assemble his team. This was all to the good, since there will be supply-side representation in his administration. In domestic policy, it will provide him with a foundation for economic revival through his tenure. In foreign policy, it can make all the difference in the world. □

Carl Gershman

HUBER MATOS AND THE COMING CUBAN REVOLUTION

Our man in Havana is in Caracas.

Cubans opposed to Fidel Castro's rule say that he has made two costly errors during the past year. The first was his decision last April to remove the guards around the Peruvian Embassy in Havana, a move that led 10,000 Cubans to seek political asylum in the embassy compound. Castro had hoped to stage a confrontation between the Peruvians and the refugees as a way of forcing a number of Latin embassies in Havana to stop providing asylum to Cubans wishing to leave the country. But the Peruvians did not turn the refugees away, and the spectacle of thousands of Cubans storming the embassy shouting "Libertad!" proved to be an enormous political embarrassment for Castro.

Castro's second error may be even more costly to his regime in the long run. This was his decision to allow Huber Matos, one of the leaders of the Cuban revolution, to leave the country after completing a 20-year prison sentence. Castro may have calculated that the 60-year-old Matos was a broken man who would live out the rest of his life in seclusion with his family and who, in any event, could do less harm to the regime from exile than as a martyred prisoner and a symbol of unyielding resistance to Communist rule. But here, too, Castro seems to have misplayed his hand.

Since his release from prison a year ago, Matos has busily sought to build a political movement for the liberation of Cuba. He has travelled widely, visiting Cuban communities in the United States, Venezuela, Costa Rica, Puerto Rico, the Dominican Republic, and Spain. These efforts resulted in the founding of a new organization, *Cuba Independiente y Democratica* (CID), at a congress held in Caracas, Venezuela, over the weekend of October 17-19.

The meeting was scarcely noticed in the United States, but it aroused intense interest in Caracas and in other Latin capitals. The main reason for this is Matos himself, who commands immense respect in the Cuban exile community and throughout Latin America. A former school teacher, Matos joined the revolution against the Batista dictatorship and became, according to the Caracas *Daily Journal*, "the bravest of the guerrillas and their most effective leader." Following the overthrow of Batista, he was put in charge of Camaguey province but resigned his post when it had become clear that Castro intended to impose a Communist dictatorship upon Cuba. On October 21, 1959, two days after his resignation, Matos was arrested and charged with treason. Castro himself was the chief prosecutor at the trial, delivering a seven-hour harangue that was broadcast over the state radio.

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Despite numerous appeals for his release and several offers for an exchange of prisoners (the Bolivian government offered to exchange Regis Debray for Matos in 1968), Matos served every day of his 20-year sentence. He spent most of this time in solitary confinement, including a full year in an underground concrete box. He was frequently beaten and in one instance,

in 1973, had several ribs broken and his left shoulder severely damaged when he was set upon by a dozen men carrying lengths of cable.

Matos emerged from this ordeal spiritually unscathed. He appears today, in the words of one Venezuelan journalist, as "the model of austere rectitude," a singularly dignified figure who remains a fervent revolutionary. He is hardly the first Cuban exile leader to have accused Castro of imposing a ruthless and economically unworkable totalitarian system in Cuba and of making the country a Soviet colony which now serves Moscow's imperialist interests. But when Matos says that Castro has betrayed the Cuban revolution, his words carry unique moral authority.

Matos' strategy is based first of all on the belief that the anti-Castro movement must have an unmistakable democratic orientation. "We must be clear about our principles," he told the Caracas meeting, "so that everyone will understand that if our struggle succeeds, it will result in nothing but a democratic state." The new organization did not endorse a particular ideology, but its declaration was social democratic in spirit, emphasizing political pluralism, social equality, and a mixed economy with a strong private sector and free trade unions. The declaration also stressed the need for Cuba to gain political independence and to revive its historic and cultural links with Latin America.

The democratic outlook of the new organization was underlined by the choice of Caracas, the capital of Latin America's leading democracy, as the site of the founding congress. (CID will also set up its headquarters in Caracas.) Venezuela's decision to allow the congress to be held on its soil was particularly significant in that its relations with Cuba have recently been strained. Just two weeks before the congress was to have opened, a lower military tribunal in Venezuela acquitted Orlando Bosch and three other Cubans who had been charged with blowing up a Cuban airliner off Barbados in 1976.