ECONOMIC SUMMIT

malaise and American decline that they have helped make the cornerstone of the Democratic party world view.

But the 1990s will see a further erosion of the potency of the Cambridge/Manhattan/Beltway position, as the census reapportions more seats to the South and West. No longer can a coalition of Middle Atlantic, New England, and Midwestern industrial states suffice to win the White House. Meanwhile, the Western and Southern states—with their stronger industrial bases, growing population, and resources (notably energy)—will continue to gain influence. Indeed, save for Gary Hart's personal peccadilloes, these forces already might have captured the party, and maybe the nation, in 1988.

Although certainly capable of protectionism, Southern and Western Democrats tend to have a different fix on the national predicament than Easterners do. They have a hard time accepting the "end of the frontier" mentality that has dominated the Democrats since the time of FDR. If you live in places like Los Angeles, Houston, Atlanta, or Miami, you have witnessed within *this* generation a massive explosion of growth in international commerce, entrepreneurial activity, and culture.

This is very significant. If you live in an emerging region, your fix on problems is more toward managing free-market expansion—what some former Gary Hart people call "empowerment"—than simply redistributing wealth among fixed populations and institutions. Northeastern liberalism has its origin in a region with near-zero population growth. But the problems of that region have little resemblance to those of California, Colorado, Texas, or Florida—where population and job gains in recent decades have been in the double digits.

Equally important, Democrats from these expanding regions often regard international trade and investment with less dread than the Northeastern establishment. In states like California, Japanese or Taiwanese capital helps keep the local economies alive. Few California Democratic politicians, for instance, adopt protectionist rhetoric like that of Rep. Richard Gephardt (D-Mo.). It simply doesn't wash in a multiracial state increasingly dependent on world trade and investment.

Of course, purists will not like the policies of even the most free-market Western Democrats. These Democrats will favor an activist government—in terms of environmental protection, transit infrastructure, and education—that many traditional libertarians might abhor. Although market-oriented, they will not push for the massive privatization of public services. But their policies would prove far more acceptable than those that now characterize the current mainstream Beltway party.

If you detect my less-than-wild enthusiasm about even these changes, you're right. The Democrats—under the best of scenarios—will adopt policies at times that are too statist, too interventionist. But in this less than perfect world, there are many reasons for people of a libertarian bent to remain allied with parts of the Democratic Party.

First, as stated above, there are forces acting within the party who are better than the established leadership. There are allies worth having on economic issues, such as New Jersey's Sen. Bill Bradley. They need to know that there is a free-market constituency for them. Someday, the Democrats will have to win an election—after all, there is Dan Quayle—and it would be good to have market-oriented Democrats inside the party.

Second, the Republicans also present many problems. Many Republicans yearn for the return of the nationalist and interventionist policies of the Nixon years, following the Kevin Phillips school of authoritarian and hierarchical conservatism. A Phillips-style corporatist industrial policy—which has natural sympathy among the mostly Republican corporate aristocracy—fits what Michael Harrington used to call "socialism for the rich," essentially, using the state to protect the current distribution of assets.

More important, the Republican party also has chosen to embrace within its core the most repressive and authoritarian elements in our society. The most important political advocates of censorship, abortion bans, and the insane "drug war" are members of the GOP. The many smart Young-Republican libertarians in Washington may scoff at the notion of putting someone in jail for smoking a joint or performing an abortion, but they provide the intellectual fodder and staff work for those who do.

Often, friends with free-market orientations are shocked that I still consider myself a Democrat, allying myself to some extent with the likes of Richard Gephardt or Mario Cuomo. Yet given the choice between such alliances and ones with protofascists like Bill Bennett and Jesse Helms, I'll accept being called a donkey any day.

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SUPPLY-SIDE GOES INSIDE

Growth Is the Issue

BY BRUCE BARTLETT

President Bush's recent abandonment of his "no new taxes" pledge has been widely interpreted as equivalent to abandonment of the supply-side economic policy of the Reagan administration. But the central tenet of supply-side economics is not that taxes should be abolished or cut indiscriminately. Nor is it correct to say that we always prefer deficits to higher taxes. The point which supply-side economics raised is that the impact of taxes on incentives and growth should be minimized as much as possible.

High marginal income-tax rates, taxes on entrepreneurial activity (such as the capital gains tax), and taxes on saving and investment are clearly more adverse to growth than consumption taxes. Because they discourage economic activity, the former have much higher "excess burdens" than the latter. (*Excess burden* is the difference between the cost of a tax and the amount of revenue it collects.)

And certain tax "cuts" might not promote growth, whereas certain tax increases might. The reason for this is that certain tax incentives may bias investment or other economic activity away from productive uses into unproductive uses. Eliminating such incentives from the tax code, while perhaps increasing taxes for those taking advantage of them, would nevertheless lead to a more productive allocation of resources, thus contributing to growth.

WHEN IT COMES TO TAXES, BUSH HAS ESSENTIALLY STUCK TO THE SUPPLY-SIDE POSITION IN THE BUDGET NEGOTIATIONS.

Last, we must note that not all tax cuts or tax increases are what they appear to be. A good example is the capital-gains tax. A reduction in the tax rate on capital gains would increase federal revenue in the short run. Obviously, the converse is true as well: An increase in the capital-gains rate would certainly lose revenue. Thus one must carefully distinguish between tax rates and tax revenue when considering changes in the tax system.

Although it is too early to say where the 1990 budget negotiations will end up regarding taxes, it appears that President Bush is holding to essentially a supply-side view:

- He continues to support a reduction in the capital gains tax as a way of stimulating risk-taking and entrepreneurship.
- He has strongly resisted the call to increase tax rates.
- He has supported only consumption-oriented taxes, such as those on alcohol, or the scale-back of tax deductions, such as that for state and local taxes, that adversely affect growth. (The federal deduction for state and local taxes essentially subsidizes state and local spending and has led to much greater spending at the state and local level than would be the case without such a deduction.)

What about the future? Where should we strive to make additional gains? Clearly, the answer depends a great deal on politics. In an atmosphere where people are obsessed with deficits, it obviously will be difficult to enact legislation that will reduce federal revenue. Moreover, it is clear that the forces of envy and income redistribution are in the ascendancy. Even Republicans like Kevin Phillips press for tax increases on the rich in the name of "equity." Still, despite such constraints, some things can be done.

First, to withstand any efforts to raise federal tax rates, we can build upon the general support that still exists for tax reform. This will put us in a better position to make gains whenever the political/fiscal environment becomes more hospitable to tax cuts. In addition, we can seek out additional trade-offs between tax preferences and tax rates in order to move toward a flat-rate tax system in a revenue-neutral manner. There are still many distortions left in the tax code, such as the deduction for mortgage interest, that we could "cash in" to finance lower marginal tax rates. Just making the argument for such a trade-off will help keep alive the issue of lower marginal tax rates.

Second, we can identify and press for reductions in taxes where a plausible case can be made that higher revenues will result. Capital gains is the obvious example, but taxes on any form of income that is particularly sensitive to the rate of return, such as business profits, might also qualify.

Third, we should encourage tax reform efforts at the state and local levels. State and local taxes are an increasingly significant element of total taxation. They are also an area where taxes have been rising rapidly. It is possible that a new round of tax revolts in states like New Jersey could lead to a new round of tax cuts in Washington in the 1990s, just as Proposition 13 in California set the stage for tax cuts in the early 1980s. A scale-back of the federal deduction for state and local taxes would greatly encourage this trend.

Fourth, we need to encourage tax reform efforts in the developing world, including Eastern Europe. Although most nations have reduced their tax rates in recent years, in response to tax cuts in the United States, many still have rates that are far too high. International organizations such as the International Monetary Fund and the Agency for International Development need to make tax-rate reduction a central element of economic reform as a condition for receiving aid.

Finally, it is not really necessary any longer to pursue an explicitly supply-side economic agenda because the central points that supply-siders made in the mid-1970s about the evils of high tax rates and the errors of Keynesian economics are now, for the most part, accepted by mainstream economists and policymakers. If supply-side economics is dead, it is due to its own success.

Bruce Bartlett is deputy assistant secretary for economic policy at the Treasury Department. The views expressed are his own and not necessarily those of the Treasury Department.

RESISTING REGULATION

A Free-Market Survival Guide

BY WILLIAM A. NISKANEN

Those of us who support continued deregulation face a daunting task. The trend in Washington, in both the White House and Congress, is toward greater regulation. Nevertheless, we should not give up hope. The economic case for deregulation remains as strong as ever. We just have to present that case to voters in an effective manner.

Much of the demand for greater regulation springs from the public's hostility to ever-increasing federal taxes and spending. Because of the intense focus on the budget deficit, special interests have generally abandoned their calls for new social spending. Instead, they now attempt to have government mandate that employers provide specified benefits for employees. This effectively hides the costs of new programs. Instead of showing up as a line in the federal budgets, new programs will be paid for by a multitude of employers.

Several mandated benefits have already been approved. Government increasingly mandates certain pension benefits. Legislation that requires advance warning of plant closures and major layoffs was approved in 1988. Congress approved legislation that requires assistance to disabled workers and customers this summer. And a bill to require parental leave was recently approved by Congress, only to be vetoed by President Bush. More such mandates are in the congressional mill, the most important of which would require all employers to provide a federally structured medical-insurance program.

Further, the partial deregulation of certain industries that was enacted in the late 1970s and early 1980s may ironically lead to new regulations in the 1990s. The federal government substantially reduced the regulation of several industries but failed to reform the remaining government roles in these industries. As a consequence, the developing problems in these industries are broadly (but incorrectly) perceived to be the result of deregulation, rather than of the failure to reform the remaining government roles.

The most striking example is the savings-and-loan crisis. Starting in 1980, the deposit rates at S&Ls were gradually deregulated, but the federal insurance on deposits was sharply increased. The combination of these conditions created a "moral hazard," in which owners of banks with low or zero net worth had an incentive to make high-risk loans, in effect gambling with taxpayers' money. We all know what this situation led to. But how many people place the blame on federal deposit insurance rather than deregulation?

Airline deregulation led to a large increase in the number of flights, but the capacity of the airports and airways system has hardly changed; no major new airport has been built for 15 years, the number of controllers has not increased, and the government has yet to permit a peak-load pricing system for congested airports. The combination of these conditions has led to increasing congestion and delays and some pressure for reregulation even though airline safety has continued to improve.

The long process of deregulating telecommunications services has also not been matched by complementary changes in the remaining government roles. New technologies have increased the demands on the frequency spectrum, but the government still manages the spectrum the way the Soviets run their economy. Cable television rates were deregulated in 1986 without permitting the entry of other cable services (most importantly, the local telephone companies) to challenge the local monopolies. As a consequence, cable rates among monopoly companies soared. But when Congress acted this summer, it did not open up cable television to new competitors; it reregulated cable rates.

In these three areas, one might almost suspect Congress and the bureaucracy of conspiring to discredit deregulation.

And good times produce new demands. When people are no longer concerned about the economy, it seems that they begin to look for other problems for government to solve. The demand for environmental benefits, for example, seems to be growing.

BECAUSE OF THE BUDGET DEFICIT, SPECIAL INTERESTS NOW CALL FOR MANDATED BENEFITS RATHER THAN NEW SPENDING.

Given this outlook, what can be done to revive the case for deregulation? The first task, I suggest, is to address each of the conditions that have led to the increased demand for regulation. A different response is appropriate in each case. Mandated benefits should be opposed without qualification, to force these demands back through the federal budget. Hiding the costs of the programs ensures that they will grow out of control. Putting them on budget makes sure that people know just what the programs cost and allows them to decide whether the benefits are worth the price.

The concern about the soundness of the banking system could be used to make the case for removing the restrictions on branching and on lines of business. The rapid increases in medical-insurance premiums reinforce the case for removing