Capitalist Revolution

Ronald Reagan defeated socialism at home, too.

By Paul Craig Roberts

RONALD REAGAN was elected president largely because of what President Jimmy Carter called the "malaise" of the American economy. A quarter century ago, the economy was mired in "stagflation." Efforts by policymakers to spur economic growth drove up inflation more than employment. Efforts to restrain inflation drove up unemployment with little impact on the rate of inflation. It was a matter of great concern that these "Phillips curve" tradeoffs between employment and inflation were worsening with each economic cycle. In a widely read article, "More Inflation, More Unemployment," economist Milton Friedman noted the complete breakdown of Keynesian demand-management economic policy.

The economy's problems had serious implications for U.S. domestic and foreign policy. Social Security, a pay-as-you-go pension system, was threatened by inadequate growth in real tax revenues. To avoid the Soviet Union achieving a supremacy that might reduce the risks of aggression, the U.S. faced an expensive arms race. An economy ensnared in stagflation could not meet these and other demands.

The Keynesian economic establishment had no solution other than an "incomes policy," which meant regulation by Washington not only of all prices but also of wages, salaries, and professional fees. With experience of controlling one price—oil—fresh in everyone's minds, to extend the regulation to all prices was regarded as a fate worse than stagflation.

The malaise of the U.S. economy, and also the economies of the UK and Europe generally, was a great source of comfort to Soviet leaders, mired as they were in intractable economic problems of their own. American economic difficulty encouraged the Soviets to continue the struggle for supremacy.

Few Americans realize, even today, that it was President Reagan's economic policy, not a military buildup, that won the Cold War by rejuvenating capitalism. Reagan startled Soviet leaders, as well as American economists, when he declared that U.S. economic problems were not inherent in capitalism but were the results of the wrong policies and could easily be fixed by changing policy.

All that was necessary to repair the broken American economy, said Reagan, was to reverse the policy mix. Keynesian demand management used monetary expansion to stimulate consumer demand and high tax rates to restrain inflation. Reagan's revolutionary supply-side message was that high tax rates were restraining real output while money growth pumped up demand. Restraining real output held down job growth, and pumping up demand exacerbated inflation. The solution, Reagan said, was simple: use monetary policy to control inflation and tax-rate reductions to stimulate real output.

The message to the Soviets was clear. If the U.S. economy could be fixed, but the Soviet economy could not, then the battle for supremacy was over. Reagan's economic message ushered in the era of Soviet economic and political reform. The Soviet reforms were unsuccessful, but the era of *perestroika* brought to light information and made possible criticism that undermined the confidence of Soviet leaders and the Soviet people in their system. It was the internal collapse of Soviet confidence that brought down the USSR, not a U.S. military buildup and arms agreements between Reagan and Mikhail Gorbachev.

Reagan's supply-side policy threatened the human capital of the Keynesian establishment. Long accustomed to thinking of tax cuts as a demand-side measure to stimulate consumer spending, the entire economics profession, along with the Federal Reserve, many Republican senators, and many in Reagan's own government, assaulted Reagan's policy with predictions of accelerating inflation that would drive up interest rates, crowd out investment, and worsen stagflation. As Reagan had inherited a double-digit rate of inflation, the prediction of accelerating inflation was so alarming that it drove up long-term interest rates to record levels.

Reagan, however, was not intimidated. He stuck to his policy. Tax rates were reduced and monetary policy was restrained. The result was a record economic expansion while the rate of inflation fell. The "Phillips curve" tradeoffs between employment and inflation disappeared just as supply-side economists predicted.

In January 1989, I compared the first 58 months of the Reagan recovery to the previous recovery, which had lasted 58 months. From March 1975 through January 1980 (the beginning and end of the expansion from the 1974 recession), the unemployment rate fell 27 percent, the consumer price index (CPI) rose 48 percent (about twice as much as the unemployment rate fell), and gross private domestic investment rose 50 percent.

In contrast, from November 1982 through September 1987, the unemployment rate fell 45 percent (about twice as much as the previous recovery), the CPI rose 17 percent (only one-third as much as the previous recovery), and gross private domestic investment grew 77 percent (about 50 percent more than the previous recovery).

The Reagan economy was remarkable in other ways. It produced the highest manufacturing productivity growth in the postwar period, averaging 4.6 percent annually from the beginning of the recovery in 1982, compared with 2.3 percent in the 1970s, 2.7 percent in the 1960s, and 2 percent in the 1950s.

The claim that Reagan had cut taxes for the rich was disproved by IRS data showing that the share of federal income taxes paid by the top 1 percent rose from 18.1 percent in 1981 to 26.1 percent in 1986—a 44 percent increase—while the share of taxes paid by the bottom 50 percent fell from 7.5 percent to 6.4 percent.

The success of Reagan's policy threatened to elevate a handful of supply-side economists above the Nobel Prize winners of the Keynesian establishment. No such indignity could be permitted. As supply-side voices were few, it was easy for the establishment to control the explanations. Many myths were created by academics, by Democratic politicians such as Sen. Daniel Patrick Moynihan, and even by Reagan's former budget director David Stockman, myths that were endlessly repeated by obliging pundits.

One of the most successful myths was that the Reagan administration made a "Laffer curve" revenue forecast that the tax-rate reductions would pay for themselves by recovering the lost revenues through higher economic growth. The "Reagan deficits" were said to be proof that supply-side economics had failed.

Two decades later economists and journalists continue to repeat this myth as gospel truth. Yet every official document shows that no such forecast was made. The budget was based on a traditional static revenue estimate that the tax cuts would lose revenues dollar for dollar. The loss of revenue from the tax cuts was placed at $718.2 billion over the 1981-86 period.

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As the Reagan administration anticipated the revenue loss from the tax-rate reductions, why did the budget deficits occur? The answer is that inflation fell faster than forecast, wiping out $2.4 trillion in nominal GNP during 1982-86, a dramatic reduction in the tax base. The Reagan budget forecast was controversial because it predicted rising economic growth and a falling rate of inflation—a "Phillips curve" impossibility. When the impossible happened and inflation fell even faster than forecast, it built into the budget higher levels of real spending than the administration had intended.

The budget deficits resulted because the supply-side policy was more successful in reducing inflation than the Reagan administration predicted. Since the budget deficits themselves were the direct consequence of unanticipated disinflation, the deficits could not possibly cause the higher inflation that so many economists mistakenly predicted.

By 1988 it was clear that the U.S. economy had escaped from malaise. But the Soviet economy had not. On Feb. 17, 1988, Gorbachev reported to the Central Committee of the Communist Party that, except for vodka sales and the higher prices paid for Soviet oil, the Soviet economy had not grown for 20 years.

Shortly thereafter the publication of Soviet economist Abel Aganbegyan's report on the failed Soviet economy signaled that the Cold War was over: "In the period 1981-85 there was practically no economic growth. Unprecedented stagnation and crisis occurred, during the period 1979-82, when production of 40% of all industrial goods actually fell. Agriculture declined (throughout this period it failed to reach the 1978 output levels). The use of productive resources sharply declined and the rate of growth of all indicators of efficiency in social production slowed down, in effect the productivity of labor did not increase."

By rejuvenating capitalism, Reagan destroyed world socialism. The UK and France privatized their economies and reduced tax rates. China's leaders reversed course, declaring, "it is good to be rich." The revolutionary re-emergence of private property out of socialism and communism is a historical watershed.

Reagan changed the world, because he did not believe capitalism was a spent force. He liberated our economy from the "Phillips curve" and chased away the malaise that had paralyzed the Carter administration and given hope to Soviet leaders. ■

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Postcard from the Edge

Iraq's neighbors share our interest in regional stability.

By Jim Pittaway

ON A LEAFY Amman side street, tucked in behind the French Ambassador's residence, the charming, quiet Hisham Hotel had, in the space of 24 hours, been transformed into something between a disaster command post and a crisis shelter. The smell of chain-smoked cigarettes mingled with the stench of too many bodies, far too long unwashed, crammed into the tiny reception area and the modest coffee shop. Cell phones clicked, and the hum of conversation was punctuated with tears of relief and cries of anxiety as humanitarian-aid workers, who had been running the gauntlet of militias, gunmen, gangs, and terrified trigger-happy U.S. troops as they fled Iraq, called around frantically seeking information on their colleagues fleeing the chaos.

In Amman to write about the situation in Iraq, for me their arrival meant a mother lode of firsthand information that could not possibly have been more current or relevant. I was surprised by their initial hostility toward someone identified as a journalist—that was a new experience for me—but it helped that I had spent some years as one of them and I had been prudent enough to bring a half-dozen issues of this magazine. So, after considerable re-introduction, they talked.

When the Marines surrounded Fallujah and began blasting their way in, a number of unanticipated events began to occur. As the civilian death toll rose, a rash of kidnappings of Western civilians began in retaliation. This was reported, but important consequences were not. According to my fellow guests, the security situation for humanitarian workers went from caution to immediate evacuation by any available means within 72 hours. The Red Cross, Save the Children, American Friends Service Committee (AFSC), and Doctors Without Borders (MSF) all were checking in downstairs while upstairs war "critic" Sen. Jay Rockefeller (D-W.Va.) was explaining to Larry King how that pocket of resistance in Fallujah just had to be eliminated to teach those terrorists a lesson and to deprive the bad guys of a "rallying point"—and if more troops were needed, well, it was high time they got sent.

Back downstairs, the red-eyed AFSC team leader folded his cell phone shut and confirmed to his relieved colleagues that the last of both their and MSF's personnel were out of country. He turned to me and said, "MSF pulled out, and this last group was working in Irbil [in supposedly secure Kurdish Iraq]. That's how bad things are in there." When I told him what Rockefeller had said, his only comment was, "So I guess those idiots don't just want us out, they must want every single Iraqi who has ever worked with any of us to get his throat cut."

Not one of these veterans of Bosnia, Sudan, Afghanistan, and conflicts dating back to Vietnam had ever seen a security situation deteriorate so rapidly nationwide. All agreed this tactic of targeting civilian foreigners had been centrally co-ordinated, objective-driven, 100 percent effective, and was employable at any time, anywhere in the Muslim world. The Romans could not have run an empire if citizens could not live, work, and engage in commerce in the provinces, but evidently Rockefeller and Wolfowitz cannot comprehend anything as simple-minded as this. Halliburton may well have its very own private airmobile regimental combat team, complete with intelligence capabilities, interrogators, and special-ops, but even they cannot operate if foreign contract-workers cannot live in the region.

More unanticipated fallout from Fallujah involved the reaction of various coalition partners who, according to several sources, went to Paul Bremer and Gen. Ricardo Sanchez and said something like this: "Excuse us, sirs, but collective punishment is a serious no-no under the laws of warfare. Your generals have announced their intent to 'teach these people a lesson' and reduce their town to rubble if Fallujans don't 'turn over the perpetrators' of crimes you allege, perhaps, as you have also said, for execution. That Ariel Sharon gets away with this kind of thing won't help us in the international courts and conventions to which, unlike him, we are signatories and participants. Our exposure out here does not extend to war crimes and if you persist, you will be very much on your own." Or something like that. This business of telling the U.S. it may find itself on its own is becoming an increasingly high-value card among nervous coali-