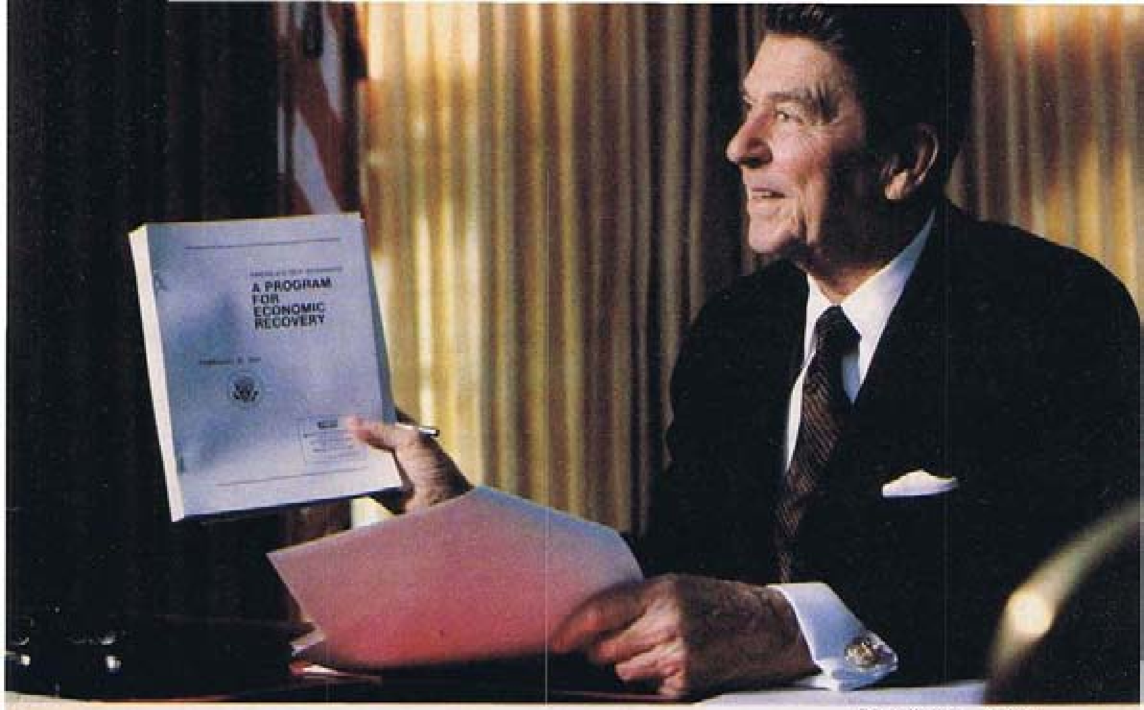

Diana Walker — Liaison

Grave Dangers On The Road To ECONOMIC RECOVERY

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■ IN HIS carefully structured and magnificently delivered State of the Union address, President Reagan promised the American people that the economy would sail out of its current doldrums and be on course to stable growth and perennial prosperity by the latter half of this year. The significance of this statement was not lost on nervous congressional Republicans who are up for re-election — or on their Democratic opponents. With that cheery economic prognostication, Mr. Reagan has mortgaged the future of the Republican Party in the critical 1982 congressional elections.

Playing the role of the steel-nerved riverboat gambler in this cast-of-millions extravaganza, the Presi-

The deficit for the first quarter of Fiscal 1982 was $48.2 billion, and if spending continues to rise at the current rate the government will be $193 billion in the red by the end of the year. Federal deficits soaked up 78.8 percent of our country's total national savings in 1982, putting strong upward pressure on interest rates.

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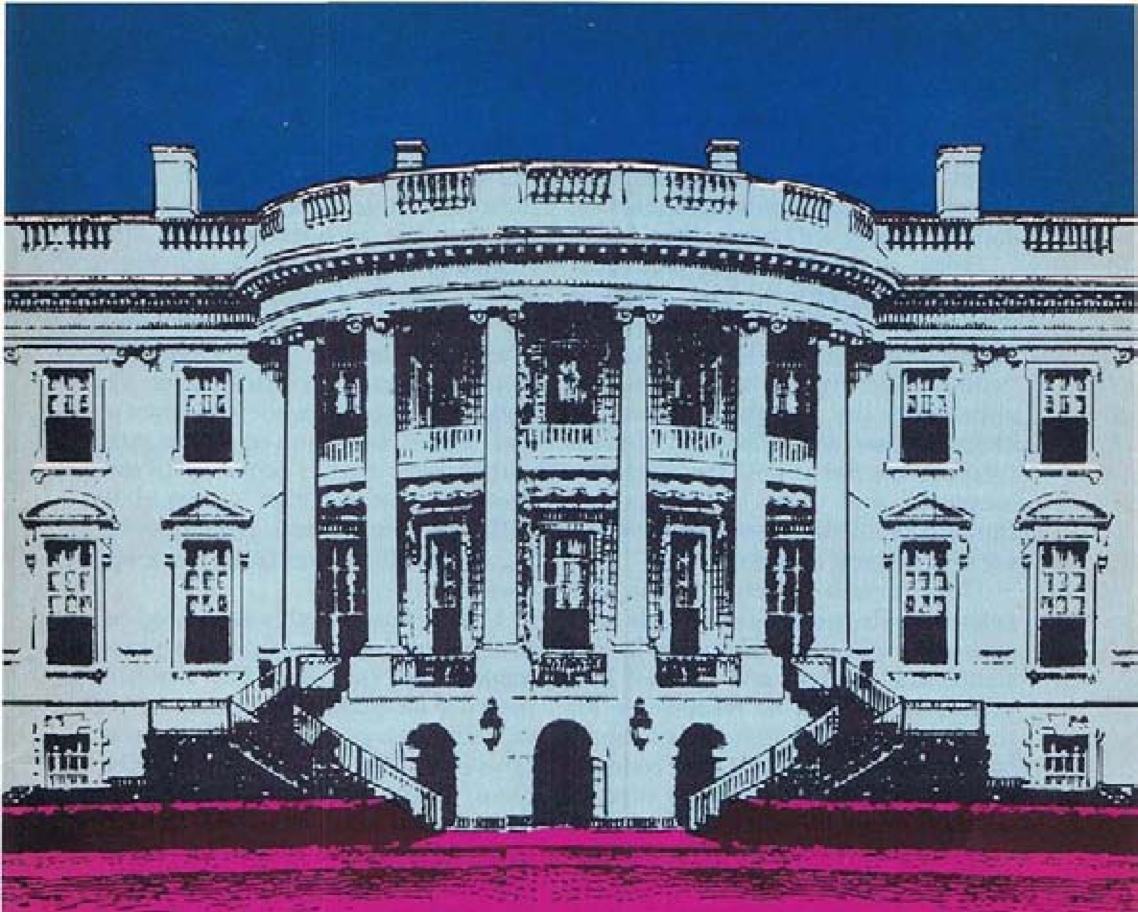
dent must roll a seven. If the economy comes up "snake eyes," there will be fewer new elephants in Washington than pizzerias in Peiping. The Republican leaders in Congress are much less optimistic than their chief, fearing that if the promised economic recovery does not materialize they could find themselves out of their congressional seats and standing in the unemployment lines.

The President also predicted that the Budget deficit for Fiscal 1982 would be held *under* $100 billion; however, figures released by the federal government the day after the speech showed that the deficit for the first quarter — the first three months of Fiscal 1982 alone — had already reached $48.2 billion! If the red ink continues to be that deep in the remaining nine months, the total Budget deficit for the year will be a torrential $193 billion! Let's hope Mr. Reagan's predictions are not based on wishful thinking. Otherwise, the Democrats will have an unanswerable issue with which to attack Republican candidates in this fall's campaigns.

After all, Jimmy Carter is now ancient history. The public's memory of the peanut farmer from Georgia has, like the famous Cheshire cat of *Alice In Wonderland*, faded to nothing but a set of grinning teeth. It will not, therefore, be an easy task for the Reaganauts to lay the blame for our current malaise at the feet of Carter and his spendthrift ways — especially since Mr. Reagan is already spending more than Carter and proposing deficits twice the size of those in the Carter years.

Will the American people lose patience with what they perceive to be the consequences of the President's economic program? Already, polls reveal that the magnetic and charismatic President is personally more popular than his policies, which are viewed as skewed towards the wealthy. It must be remembered that the U.S. electorate is extremely fickle, and abysmally deficient in understanding of the nuts and bolts of economics. Many people think that six months is long enough to be patient. They don't know a business cycle from a motorcycle, or the Federal Reserve from a game preserve. Many have *already* begun to lose patience with the Reagan program for economic rejuvenation. Recent opinion surveys indicate that unemployment has now replaced inflation as the nation's Number One worry. After all, if it comes to a choice between worrying about losing ten percent of their purchasing power to inflation or losing one hundred percent of their purchasing power by losing their jobs,



Cut Government Or It Will Cut Our Throats

	Carter's FY 1981	Reagan's FY 1982*	Reagan's FY 1983†
FEDERAL BUDGET	**$660.5B**	**$725.3B**	**$757.6B**
BUDGET DEFICIT	**$57.9B**	**$98.6B**	**$91.5B**
NATIONAL DEBT	**$999.8B**	**$1.079T**	**$1.25T**
INTEREST ON DEBT	**$95.6B**	**$115.7B**	**$132.9B**

*Estimated †Projected

you can be sure Americans will worry about their jobs. Unemployment is now at the highest level since the Great Depression — and Reagan's enemies in Washington, Manhattan, and Cambridge are blaming him for it.

Being politically naïve and economically ignorant, the average American sees the current recession as the result of the Reagan Budget "cuts." The typical voter does not appreciate the length of time between causes and effects in the interplay between politics and the economy, and fails to understand that our problems have been developing over several decades.

Our current recession was not caused by Reaganomics. The tax-rate reduction effective this year is not significant enough, and has not had sufficient time, to be responsible for the $100 billion deficit which looms in the immediate future. President Reagan was counting on his supply-side incentives greatly to increase the amount of savings in order to accommodate funding of the unmonetized portions of the government's huge deficits. While it is true that the proportion of after-tax income saved by Americans has increased from 5.1 percent to about six percent since Mr. Reagan took office, this rise is not large enough to accommodate the runaway deficits now expected and still leave enough credit for private borrowers. That clearly means higher interest rates.

But the recession is the consequence of the high interest rates necessitated by the large deficits already generated by the spendathons of previous Administrations — especially including that of Jimmy Carter. This accumulated overspending, coupled with the monetary policies of the independent and privately controlled Federal Reserve, has resulted in the current crunch.

Like a heroin addict, the U.S. economy is now hooked on increasing doses of monetary inflation. It does not require a total cessation of inflationary injections for the economy to suffer withdrawal pains. The economic body is so addicted that it is accustomed to continually *increasing* doses of the inflationary dope. Since October of 1979, when Paul Volcker became chairman of the Fed, monetary expansion has continued. But it has done so at too moderate a pace for the economy to continue its narcotic high — especially with massive federal deficits soaking up the life-blood from the credit markets.

Unless much of this sea of red ink is monetized (turned into new phony money) by the Fed, the resulting pressure on private borrowers by the federal sump pump will keep interest rates rising like a geyser. On the other hand, if the Fed *does* begin to inflate in earnest, that will set the stage for eventual runaway inflation — and long-term interest rates will be bid up anyway. It is your basic dilemma, a Mexican standoff being played with M1 statistics instead of *pistolas*.

Most people do not even understand that the Federal Reserve isn't owned by the federal government, and that its policies are by law independent of the President in power — a fact that clearly frustrates the present Administration though the President dares not do more than hint at the fact lest he alienate the financial *Insiders* of the megabanks.

Meanwhile, as Fed Chairman Paul Volcker and Treasury Secretary Donald Regan (both members of the Establishment's Council on Foreign Relations) point fingers of blame at one another for the deepening recession, the American people are told by

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ECONOMY

the media propagandists that the difficult times are the fault of the widely trumpeted Reagan "cuts" in taxes and spending. Both the Left-leaning media and the "Liberal" Democrats are assuring the public every day that the recession is Reagan's recession, that the high interest rates are Reagan's high interest rates, and that the Budget deficits are the direct result of Reagan's economic policies. Because of their lack of understanding, many Americans are accepting this nonsense as gospel.

The reactionary "Liberals" are like the bartenders who poured the drinks and then blamed the hangovers on aspirin while advocating another round of martinis as the cure. Although it is grossly unfair, the "Liberal" Democrats have thrown the party and a succeeding Republican Administration is stuck with treating the resulting hangover.

Richard ("We are all Keynesians now") Nixon understood the politics of this very well, and while giving speeches promising to control the Federal Leviathan he opted for more "hair of the dog." Gerald Ford and Carter continued the binge. Lucky Ronnie now must ask: "If not now, when? If not us, who?" Good questions. But you can bet your last copy of *A Choice, Not An Echo* that the President does not want to go down in history as Ronnie Hoover marching the elephant of the G.O.P. into extinction with the wooly mammoth.

The problem, unfortunately, involves not only the economic illiteracy among the public, but also the widespread lack of understanding of Free Market principles among those elected to Congress. Many people seem to believe that former mayors and dogcatchers suddenly become brilliant, knowledgeable, and virtuous because they happened to win a congressional election. Being able to persuade a sufficient number of voters to put you in office, however, guarantees neither economic sophistication nor moral integrity. In fact, it should raise suspicion on both counts. Politicians are generally superficial, pragmatic, and amoral rather than men and women of knowledge and virtue. In a Free Market, competition tends to result in the best rising to the top. In the stage-show competition of the political arena, it is the master con man who is king.

One of the rare exceptions to the above assessment is Congressman Ron Paul, the libertarian Republican from Texas. Debunking the notion that our woes result from the President's "excessive cuts," Dr. Paul observes that, "on the contrary, the economic problems we face today are not the result of too *many* cuts — they are the result of too *few*. The move in Washington to raise taxes and reject needed spending cuts demonstrates that Congress has not turned from its big-government policies which created our problems in the first place. If the President is to succeed in his efforts to provide economic recovery for our nation, it is imperative that he have support from Congress for real cuts in spending, taxes, and regulations. I hope Congress will have the courage to provide this support in 1982."

As we have repeatedly pointed out in this magazine, there has been neither a tax cut nor a Budget cut. The tax-rate reductions in Mr. Reagan's economic package, while sorely needed and appreciated, are only beginning to take effect and do not even offset the built-in tax hikes in Social Security and inflationary bracket creep already programmed by the Carterites. Also, contrary to all the wailing and gnashing of teeth in the media over the alleged Budget "cuts," spending for 1982 is already more than $60 billion over what was spent in Fiscal 1981, and more than $100 billion higher than the original Carter estimates for that year. This does not even include the so-called "off-Budget" outlays of nearly $30 billion or the federal loans and loan guarantees which amount to an additional $60-$100 billion.

Since federal spending must be paid for either by direct taxation, borrowing from private savers, or with newly created phony money (inflation), the burden of all this spending and debt is excruciating and continues to increase. As *U.S. News & World Report* put it under date of January 18, 1982: "Remember the Reagan pledge to cut Federal spending as a percentage of the nation's total output of goods and services? Try as he might, it didn't work. The percentage was 23.1 in 1981. In 1982, according to the latest unofficial estimates, Federal spending will hit 23.8 percent of the Gross National Product. Reason: despite all the cuts, Federal spending is still rising faster than the recession-cooled economy."

Some readers may recall that in the 1980 Scoreboard issue of this magazine your correspondent reviewed an important study by Dallas University Professor H.A. Merklein which was originally published in the August 1, 1978, issue of *World Oil*. From careful analysis of fiscal trends based on data available at the time, Merklein projected that by 1983 federal deficits would gobble up all the net capital generated by savings and investment. At that crucial point, the government would no longer be able to borrow in order to pay the interest on the National Debt. Dr. Merklein observed gravely:

"For the nation as a whole, this is the day when private investment is limited to replacing worn-out capital goods, and less than replacing them, since the on-going inflation rate will render capital consumption allowances insufficient for that purpose. That is the day when the United States stands before the world with a magnificent system of Medicare, Medicaid, unemployment insurance, and other welfare programs that, for political reasons, it is incapable of reducing, while it can no longer finance the interest charge on its debt through borrowing."

At this point the government will have to print its way out . . . or try to. What else can it do?

While we are not yet at that desperation point, the trends on which Merklein's conclusions were drawn are continuing. In the December 16, 1981, issue of his *Dow Theory Letters*, market analyst Richard Russell published a table which shows federal and federal-related borrowing as a percentage of total net national savings. In 1979 the Federal Sponge was absorbing 46.7 percent of everyone's savings. In 1981, only two years later, it was soaking up 78.8 percent of total national savings!

Is it any wonder that interest rates have been reaching for the moon, and that small- and medium-sized businesses are being strangled to death in a liquidity crunch? This may also help explain why U.S. business profits in 1981 were $29 billion *less* than was paid out by the business community in interest charges, while three years earlier profits exceeded interest payments by $72 billion. Meanwhile, with many firms in quiet liquidation, certain big Establishment corporations — the Friends of the Fed — have plenty of credit at their disposal for corporate takeovers and mergers. Forecast for 1982:

The Fortune 500 could become the Fortune 250!

Any portion of the Debt which cannot be accommodated by borrowing from the existing pool of savings, of course, must be monetized by the Federal Reserve. The hyperinflationary powers granted to the Fed in the Monetary Control Act of 1980 stand ready for a massive bailout operation which would bring on runaway inflation. Meanwhile the tremendous deficits, high interest rates, and record-level unemployment feed upon each other in a vicious circle, like a dog chasing its tail. Consider.

For every percentage point that unemployment increases, the federal Treasury loses $25-30 *billion* in revenues. This widens the Budget deficit by reducing revenues and also by triggering various "entitlement" expenditures which increase automatically during recession. As a recession deepens, more outlays are triggered for workman's compensation, Welfare, and so forth, which only aggravate the situation even further. Poor President Reagan. Unless something is done to control these recession-induced expenditures, the President may never be able to get the economy out of the mud.

President Reagan can always instruct David Stockman to use a meat axe on that 1983 Budget! But will the Members of Congress have enough courage and understanding to enact real cuts in government? Consider the intense political pressures which they will have to withstand.

One major obstacle to heavy Budget cuts is that a large portion of the U.S. population is now dependent on government. On March 9, 1981, *U.S. News & World Report* observed that more than half (50.2 percent) of all Americans now rely on pay, pensions, Welfare aid, or other forms of income from federal, state, or local governments. This is up from 36.7 percent for 1960. Given the recession, this percentage is rising even higher.

Economist Anne D. Willard of the firm of A. Gary Shilling & Company, who calculated the estimate, explained: "We counted people as government beneficiaries when the income they received seemed sufficient to create a voting bloc — a group of people who would set up some serious yelling and screaming if anyone tried to take their goodies away from them."

In other words, half the people in this country are living off the other half. To fully comprehend the magnitude and impact of those figures, ask yourself these questions: Do you know anyone currently receiving some form of government money who doesn't want it to continue? Indeed, do you know any recipient who doesn't want still more?*

Many of these recipients have already been organized by would-be power brokers and self-styled minority leaders to oppose any political threat to the Welfare State. There is the Welfare Rights Organization, for instance, which maintains that its members have a "right" to some of the wealth earned by others. Also vociferous in their opposition to any hint of Budget cuts are such groups as the N.A.A.C.P. and the National Urban League. Claiming to represent American blacks, the chairmen of these

*Consider that the average Welfare family in New York receives about $18,000 a year in cash and government services — all tax free — contrasted to the average family of four getting by on about $14,000 a year of taxable income. How many of those on Welfare really want to go to work and thereby reduce their standard of living? The way things stand, they have no immediate financial incentive to leave the system. In the name of fighting poverty, government has in fact tended to institutionalize it by trapping people into it as a way of life.

organizations are in fact only seeking to preserve their power bases by keeping people dependent on the Federal Plantation. Such "civil rights" groups, supported by "Liberal" lobbies, Leftist unions, and federal subsidies, have plenty of political clout in opposing what they perceive to be the "Reagan Hood" practice of taking from the poor to give to the rich.

The organized Welfare recipients and the bureaucrats who administer the programs constitute a growing voting bloc — a built-in constituency with a powerful vested interest in perpetuating and expanding the burgeoning Welfare State. This aspect of Big Government has thus become virtually self-perpetuating. The Age of Envy, as Dr. Gary North calls it, is now institutionalized.

Not only is this true of Welfare programs for the poor, but also Welfare programs for the rich. Loan guarantees to Chrysler, for example, are corporate Food Stamps. And you may expect that Ford and others will soon be joining the line.

Upon entering his job as Director of the Office of Management and Budget, David Stockman sought to achieve equitable cuts all across the board, including both Welfare programs for the poor and Welfare programs for the corporate rich. The plan was not only to cut wasteful Social Welfare transfer programs, but also the special-privilege funding which diverts taxpayers' money into the pockets of powerful corporate entities including the international banks. Stockman's idealism was shaken, however, as he ran up against the influence the giant corporations have on Ronald Reagan and the Republican Party. Program by program, the White House declared more and more Budget areas to be off limits to the Stockman axe, while other programs were exempted in congressional horse trading.

First, the President excluded three-quarters of the Budget's largest component — federal transfer payments. These were the so-called "social safety net" programs which were not to be touched. Touching Social Security is politically unthinkable. And, given the threat of the Soviet buildup, it was felt that the defense sector would have to be increased. Interest on the National Debt is now about $100 billion, and it too could not be cut.

For the most part, then, this left only two other areas of the Budget from which the "cuts" might come: (1) grants to states and local governments, and (2) traditional government operations, including such items as national parks, the weather bureau, the F.B.I., and the foreign service. These components amount to only seventeen cents of the federal Budget dollar, while transfer payments take forty-eight cents, defense a quarter, and interest a dime.

As the brilliant economist Thomas Sowell observed: "One of Stockman's disillusionments was over the painful contrast between the theory of reducing government spending and the practice. In theory, all spending can be cut. That means big cuts over all, but spread around so that no single group has to bear the main burden. In practice, it was a lot easier politically to cut food stamps than it was to cut the huge agricultural subsidies that made food artificially more expensive in the first place. It was a lot easier to cut CETA than it was to cut business subsidies. This had nothing to do with economic theory, whether laissez-faire or supply-side economics. It has to do with politics.

"Conservative politicians are politicians first and conservatives second. For some of them, 'free enterprise' means helping business and farmers instead of cities and poverty programs. They are simply liberal big spenders for different groups. Stockman finally concluded that 'there are no *real* conservatives in Congress!' "

Indeed, we are already hearing from the Congress: "We've gone about as far as we can go in cutting spending." Especially distressing is that this line of defeatism is not only being spread by the Democrats, but also by the President's supposed allies — Republicans like Howard Baker of Tennessee, Robert Dole of Kansas, Pete Domenici of New Mexico, and Representative Bob Michel of Illinois. Federal spending analyst Donald Lambro refutes this claim, observing: "True, there are many places where entitlements can and should be cut. But the discretionary side of the ledger is still loaded with expenditures that could be sharply cut without harming the neediest of our society. Over the past year I have uncovered tens of billions of dollars in spending that could be curtailed or eliminated entirely." Let us hope that Congress will act on the famous list of $100 billion in proposed slashes offered by Mr. Lambro.

Meanwhile, key "Liberals" are screaming that the 1982 Reagan Budget has nothing in it for the poor and elderly. Refuting this amazing charge, columnist John D. Lofton Jr. writes: "Nothing left? The Reagan budget has *nothing* in it for the poor and elderly? Not hardly. According to the Office of Management and Budget, the 1981 budget will spend $349.3 billion on so-called human resources, which includes education, employment and social services, income security, veterans benefits, and health care. According to OMB, it is estimated that the Reagan budget will spend the following on human resources: In 1982, $364 billion; in 1983, $391 billion; in 1984, $417 billion; in 1985, $446 billion; and in 1986, $472 billion. Thus, from 1981 to 1986, Reagan's own budget proposes spending an estimated $2.4 trillion on human resources."

A whopping $2.4 *trillion*! Compare that with the $1.5 trillion to be spent on national defense during that same time, which the Left is so exercised about! And from where will that money come? After all, the American economy is in the midst of a deepening recession. Consider the following major problems, all of which are related in one way or another to federal Debt, taxes, excessive spending, and crushing regulations.

Unemployment, as previously noted, is at record levels — reaching as high as forty to fifty percent among young blacks in the big cities. As economic conditions get worse, discontent and rising tensions could erupt into urban violence as expectations are frustrated.

The housing industry is in the worst situation it has suffered in thirty years. High mortgage rates and building costs have put ownership of a home out of reach of a great majority of young Americans. Enormous sums of money have been borrowed against home equities as people attempt to deal with the cash squeeze. This is taking the form of second, third, and even fourth mortgages due (on an average) in three years. Many homes are now being bought with "creative financing" techniques involving balloon payments. Some of these will soon be due. People assumed that their loans could be refinanced, but with the chronically high and volatile interest rates, from where will the money come? Unless a Federal Reserve bailout temporarily eases the liquidity

The descent of the economy into hyperinflationary depression can be interrupted by a period of temporary prosperity brought about by reduction of the capital gains tax and the capital gains holding period. Americans can use this opportunity to replace radicals in Congress with movement Conservatives.

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problem, the number of defaults and mortgage foreclosures could explode to unheard-of highs. For those staying liquid, there could be bargains later.

Bankruptcies are at the highest level since the Great Depression, and will continue to increase in 1982 as more businesses succumb to the money squeeze.

Auto sales have plummeted to the lowest level in two decades. This means Detroit and related industries are in a depression already. Tens of thousands have been laid off and are running out of unemployment benefits.

The stock and commodities markets are in the doldrums, going nowhere. Many brokers are packing up and leaving the industry.

Thrift institutions are being driven to the wall by high interest rates. Richard W. Kopcke, the chief economist for the Boston Federal Reserve Bank, was quoted in the October 29, 1981, *Washington Post* as admitting that two out of every three of the nation's savings and loans are technically insolvent when their assets and liabilities are calculated at realistic current market prices. The *Daily News Digest* of January 6, 1982, reports that of America's 3,855 savings and loans, "nearly 200 S&L's are at the failure point (where their net worth is zero), 300 will reach that point within 12 months at current rates, and another 900 would see their net worth sink below 4% of liabilities (the minimum considered healthy by the FSLIC). Net worth of U.S. S&L's fell $4.3 billion in the first 11 months of 1981."

Another prolonged surge in interest rates could wipe out one-third of all thrifts in a very short time. The cost of bailout by the federal government could run from $30 billion to as high as $200 billion! From where will that money come?

The banking industry, while not in as bad a shape as the savings and loans, is also headed toward precarious financial times. Loan defaults by the Communist-bloc governments or the Less Developed Countries could trigger a banking panic that would require the Fed to initiate a massive bailout leading to hyperinflation. In early February the federal government picked up $71 million worth of Polish debts owed U.S. bankers. Not to save Poland from default but to prevent a banking panic in the West.

Given all of these trends and troubles, Ronald Reagan and the Republican Party face political annihilation. Mr. Reagan is increasingly losing support for his programs. He is being blamed for our current recession by people with short memories who do not understand economic cycles. As Dr. Gary North observes: "If Thatcher's 'economic miracle' led mainly to increased value added taxation (VAT), and the 'Iron Lady' seems unable to whip up confidence in the system, what can British businessmen expect when the Conservatives get tossed out? Would you invest under such conditions? Now, if Ronald Reagan's program heads for the same rocks, what will American businessmen do? They will abandon ship." Reagan desperately needs an economic miracle — a rabbit he can pull out of his hat.

Last month we discussed four possible scenarios for the U.S. economy: (1) runaway inflation, resulting from the monetization of exploding deficits to keep building the gargantuan Debt pyramid until the dollar collapses into utter worthlessness; (2) a classic deflationary depression like the one that occurred in the 1930s; (3) a permanent soft landing as predicted by the optimists who believe that Reaganomics will have enough impact to save the day, bringing zero percent inflation, very low interest rates, and substantial economic growth by 1984; and, (4) an economic "whipsaw" consisting of two stages. The first is a deepening of the current disinflationary recession, which will scare people out of inflation hedges and serve as an acquisition period for those big *Insider*-controlled corporations that are "Friends of the Fed" while they buy up distressed firms at low prices, taking tax write-offs for the full, original face value of the assets. The second phase of this one-two punch would consist of a massive inflationary bailout by the Federal Reserve to keep the recession from becoming a full-scale depression — thereby setting the stage for hyperinflation which will take investors by surprise.

Still another possible scenario, not discussed last month, is what Donald S. McAlvany of *Gold And Monetary Report* has called an "eco-spasm," in which aspects of both "deflationary" and "inflationary" forces exist in various sectors of the economy side by side, with an inflationary recession giving way to an inflationary depression characterized by confusing and chaotic economic signals and events. Here, as powerful trends clash and interact, the economy would experience depressions in selected sectors (such as the auto, housing, and construction industries are in already), while other areas are experiencing a boom. After a time, this unstable, schizoid economy would give way to a full-scale depression amid hyperinflation — scenario Number One, discussed last month as the most probable means of ultimately resolving the Debt crisis.

The problem with all the above hotly debated forecasts is the element of timing. Most of those who are now predicting that a deflationary depression is just around the corner have been singing that song for many years. They could never be sure what the behind-the-scenes manipulators had up their sleeves. Every time the bust seemed imminent in the past, the Establishment *Insiders* in charge of the game were always able to postpone the day of reckoning by retrieving a card from their sleeves to keep the game going until they could win all they wanted before switching the rules. They have been able to sustain this floating inflationary game for longer than most observers believed possible. However, it is increasingly clear that the financial sharps are getting very near the end of their bag of card tricks. Without a return to sound fiscal and monetary policies there will come a time when a collapse — either deflationary or hyperinflationary — will be upon us and no amount of shuffling will further postpone it. The question is when that will come.

This matter of timing is important to President Reagan. If the Great Crash comes now, during his term of office, he will go down in history as the Herbert Hoover of the 1980s. No President wants that appellation if he can help it. Mr. Reagan is desperately anxious to save the situation. But he must now realize that what is politically possible might not be enough.

Let us therefore examine one last and fascinating thesis; a scenario in which the transition from the current disinflationary recession to a hyperinflationary depression would be interrupted by a "crack-up boom" lasting perhaps twenty-four to thirty months before deflation or runaway inflation sets in. That would be just long enough a postponement of the crisis to assure it would fall in the lap of the next President rather than that of Ronald Reagan. It would in any case buy sufficient time to deal with the cause rather than the symptoms of our economic illness.

In the beginning of this crack-up boom, the economic "shot in the arm" would lower interest rates; revive capital markets, construction, real estate, and commodities; and, send the Dow Jones Industrial Average skyrocketing to the dizzy level of 3000!

Because 1982 is a pivotal year, we will soon know whether this last card up the economic sleeve will be played. Your scribe will now reveal the telltale clue to watch for — the signal which will indicate that the conspirators have decided to set the clock back so that 1982 will be more like 1927 than 1929, allowing the *Insiders* to enjoy one more ride up the financial roller-coaster before they move to get off at the top.

What could the Administration and Congress do that would put new life into the economy, take pressure off interest rates, increase the availability of capital, and encourage greater productivity? What would be dramatic enough to serve as a jolt, spurring business confidence in economic recovery?

Answer: Elimination of the capital gains holding period and elimination of, or great reduction in, the entire capital gains tax.*

The "holding period" on capital gains is the length of time established by law that one must hold an asset, without selling it, before qualifying for the capital gains tax rate (which is usually substantially less than the rate for other income).

During one of the political brouhahas staged in the name of "tax reform," Congress in 1976 voted to extend the holding period from six months to nine months (effective for 1977) and then to the now-standing time requirement of a year and a day, which went into effect in 1978. These extended holding periods have placed rigidities in the equities market that have greatly choked activity.

For example, let's say that you have bought a stock at one hundred dollars per share, then find that one month later the value of that stock

*The capital gains tax is imposed on the gain accrued in any investment, whether it be in stocks, real estate, or commodities. For example, if you buy stock in the Widget Corporation for $100 and sell it at a later time for $150, your capital gain is $50. Effective this year, the maximum tax on capital gains is 20 percent, but to qualify for this tax rate, one must hold an asset for at least one year and a day. If a transaction does not qualify for long-term capital gains, it is taxed as short-term capital gains, which is the same rate as ordinary income.

has risen to one hundred fifty dollars. You have reason to believe your stock has peaked in price at that time — but are inhibited from selling and taking your fifty-dollar profit because of the high tax you would have to pay on it. If you wait a year before selling, in order to take advantage of the lower tax on long-term capital gains, the value of the stock could have plummeted. Much can happen in twelve months, and there is great uncertainty today.

Bill Lupien, a former president of the Pacific Coast Stock Exchange, gave us his assessment of the situation:

"The holding period has a tremendous impact on the velocity of turnover in the securities industry when you have to hold an asset for a year *versus* six months or even less. Shortening the holding period would increase the potential for commission income in the industry, of course — but it would also do something else that is more important. It would shorten and make more flexible your time horizons on your investment perspectives. Markets are so uncertain that we are in 'Future Shock' today. Consequently, to try to get a clear picture of what an investment will be like a year or more in advance is much more difficult than short-term investments.

"The liquidity of the marketplace has been reduced considerably simply because it has been individuals who have traditionally taken up the slack when an institution or institutions want to sell. Now that we have one side of that equation inhibited from making investments, because of the lengthy holding period, the effect has been that overall liquidity has been reduced considerably."

In the January 18, 1982, issue of *Barron's*, Robert M. Bleiberg argued strongly that ending the capital gains holding period would benefit everyone in the American economy. Like Lupien, Bleiberg points out that the abolition or shortening of the holding period would have a potential impact far beyond Wall Street. He writes:

"For one thing, by giving those who buy and sell securities more room to maneuver, a change in the law would vastly expand . . . their profit-making potential. In recent years, as one knowledgeable member firm partner has demonstrated, holders of such blue chips as American Telephone and General Motors time after time have watched a short-term gain turn into a long-term loss. It would also automatically broaden and deepen liquidity in the equity markets, thereby encouraging the sale of shares to the public and stimulating capital formation. Finally — no small consideration these days — studies suggest that like the slash in the capital gains tax, it would end up bolstering the Treasury's revenues."

In this connection, the reduction of the capital gains tax from forty-nine percent to twenty-eight percent in 1979 actually increased the revenue to the government, even though the Carter Administration had opposed the tax-rate cut on the claim that the Treasury would lose billions of dollars. When the top marginal tax rate on capital gains was forty-six percent, revenues from the tax steadily decreased from 1961 to 1963. As a consequence of the across-the-board tax cut in 1963, the maximum tax rate on capital gains was reduced to thirty-five percent. Instead of cutting the revenue, this lower rate of taxation had the supply-side effect of greatly increasing tax revenues — by twenty-five percent in 1964 and twenty-seven percent in 1965!

In an article entitled "Why The Capital Gains Tax Should Be Slashed" that appeared in the May

23, 1981, issue of *Human Events*, economic specialist Warren Brookes observed:

"By 1968, [*revenues from the capital gains tax*] had nearly tripled in constant dollars, at a substantially lower marginal tax rate. Unfortunately, this magnificent growth in capital gains and investment was hit hard; first by a surtax in 1968-1969, and then by the infamous hike on capital gains put through by Senator Edward Kennedy in 1969, which had the effect of raising the top marginal tax on capital gains to its highest level in U.S. history, 49 percent in 1970.

"The results were immediate and devastating. Tax revenues from capital gains plummeted, and over the next eight years remained consistently at a level nearly $1.5 billion lower than they were in 1968! The U.S. equity (stock) market for new issues crashed from more than 700 new issues in 1968-1969 down to less than 20 in 1977."

On the other hand, as Brookes goes on to point out, when Congress passed the Steiger Amendment which reduced the tax from forty-nine percent to twenty-eight percent, effective in 1979, liquidity and capital growth were vastly stimulated: "The results, in constant dollars, were stunning and immediate. Both capital gains and tax revenues went *up* substantially, despite a reduction of more than forty percent in tax rate!" Brookes continues:

"And, in current dollars, revenues went up by a billion dollars in the first year, 1979, an increase of more than 15 percent in revenues and 44 percent in total gains. What's more, 1980, a recession year, turned out to be the largest year for new stock offerings since 1972, with total offerings from 81 in 1979 (with a value of $506 million) to 237 offerings in 1980 (with a total value of $1.4 billion)."

The Reagan tax package passed by Congress had the effect of reducing the top marginal tax rate on capital gains from twenty-eight percent to twenty percent, and that takes effect this year.*

While the amount of revenue to government affected by the capital gains tax is not very significant, the total impact that its removal would have on the market would be far greater. Much time and money is wasted in avoiding the tax, while assets are frozen out of many short-term gains that will never be realized. As Robert Bleiberg says in his editorial commentary, "The U.S. stands almost alone in the Western world in imposing a tax on capital gains, to say nothing of a holding period. (Japan, as it happens, has burdened itself with neither.) Not surprisingly, perhaps, the U.S. in the Seventies enjoyed one of the lowest rates of growth. [*And Japan enjoyed one of the highest rates of growth.*] On this score, shortening or abolishing the holding period might do wonders for new equity issues . . . . While an undeniable windfall for brokers, any increase in trading volume that would follow would also inevitably increase the breadth and depth of the market, thereby making it easier and cheaper to buy and sell. With little or no downside risk, the elimination of the holding period holds the promise of handsome reward."

America's capital gains tax — and the ridiculous holding period — have caused incalculable harm to economic growth. There is no way of knowing how much capital has been lost or how many new firms have not come

*The capital gains tax rate for corporations is still twenty-eight percent, since the tax-rate reduction holds only for individuals.

into existence because of this tax structure. Capital — the essence of capitalism — rather than going into the equity markets, goes into hiding — usually into debt instruments. This shrinks the pool of venture capital for new firms. Older firms take on more debt by borrowing from the bankers, rather than selling equities to raise the needed capital. There would thus be enormous potential unleashed if the holding period were eliminated, especially if the capital gains tax were greatly reduced or abolished.

Markets are in the doldrums. As the recession deepens, people are bearish on virtually all investments. Consumers are afraid to make major purchases on credit because of sky-high interest rates and the fear of unemployment. The public needs a positive shock to turn investment psychology bullish. Slashing the capital gains tax and abolishing the holding period would give the economy a tremendous jolt of adrenaline, with a ripple effect throughout the economy. A secondary consequence would be that Ronald Reagan could become the Pied Piper of the Elephants and lead a triumphant procession of Conservative pachyderms into Washington, D.C., in November.

Tens of billions of dollars will come marching out of money-market funds and go into capital markets and savings and loans. Not only would the Dow Jones take off like a Saturn rocket, heading for 3000, but real estate and the construction industry would rise from the ashes like the Phoenix. "Happy days are here again!" the elephants will shout as they purloin the Donkeycrats' theme song. Only cynics, or those who know business cycles and see this as a replay of the 1927-1929 fiasco, will be humming "One More Time."

If you know what game is being played, you can march along with the *Insiders*. But, make sure you get out in the equivalent of 1929, or you will ride the roller-coaster all the way to the top and then all the way to the bottom. You can rely on the fact that the *Insiders* are likely to try to bail out just as the public jumps aboard the plane to perpetual prosperity. When would be the proper time to bail out? A very sophisticated stock-market investor tells your correspondent: "On the day the Dow-Jones volume hits 100 million shares, grab your profits and run for cover!"

In any case, there would be some tough political difficulties in getting this trump through Congress.* Because it would require bipartisan support, and because the Democrats have no desire to make the President look good during an election year, this measure will pass only if the Wall Street Left does some arm-twisting on reluctant Donkeys.†

So, it depends on the *Insiders'* pri-

*Indeed, there was an unsuccessful effort last year to reduce the holding period to six months. Bleiberg recalls the following: "Last summer, when the struggle for the Reagan tax cuts was at its height, Rep. Kent Hance (D.-Texas), a 'boll weevil' who supported the program, made the securities industry an offer it couldn't refuse. In return for more enthusiastic and effective support (which prior to that time and since has been lukewarm to cool), the Congressman, with White House blessing, tacked on a last-minute amendment which whittled the capital gains holding period from a year and a day to six months. Though the brokers kept their end of the bargain, the Hance amendment — reportedly at the urging of the senior member of the Ways and Means Committee, who reportedly takes a dim view of fence-jumping — lost out in the subsequent conference give-and-take. For one brief shining moment, the financial community nearly saw an impossible dream come true; then the moment passed."

†One of the powerful backers of eliminating the holding period is *Insider* George Ball, formerly of Lehman Brothers, who is now on the board of E.F. Hutton. When he speaks, politicians listen!

orities. By letting the disaster come now, they would on the surface gain much by embarrassing Reagan and thereby discrediting Conservatism. But, other factors might take precedence.

What would make it in the interest of the *Insiders* to see that such a measure passes next time? Money for one thing. It would be in the immediate interest of certain Establishment corporations and individuals, increasing their opportunities for taking large capital gains. Last March an article in *Barron's* reported that, "since early 1979, owners of American Telephone (at least until last year's run up), General Motors, and IBM could not profitably surmount the hurdle of the year and a day. Contrariwise, a six-month holding period, or none at all, would have yielded them several opportunities to nail down what in retrospect were handsome capital gains."

What reasons could the Reagan Administration and the *Insiders* use to get the Democrats to allow the measure to move through Congress? On the surface, it would go contrary to the vicious Politics of Envy game for the Democrats to permit reduction of capital gains taxes. But, if the *Insiders* apply the pressure, key Democrats will find rationalizations — and valid ones at that — to support the move. As we have seen, they have been induced to do it in the past. Even though the "Liberal" Democrats do not want to pass legislation which the Reagan Administration can take credit for, making the Republicans look good in the elections, they could be persuaded to go along if the credit were publicly shared with them and they could make it clear to their constituents that they were doing it not to help the rich but to help increase revenues to the government and thus reduce the deficit, restore capital markets, and slash interest rates. Much stranger things have happened in Congress, and if the Democrats could use the issue to make themselves look like gallant saviors of the economy they would go along with it. As Bleiberg and others observe, "It would benefit everybody!"

If the holding period is eliminated, it is likely to trigger a spiraling succession of positive events which will produce that euphoric crack-up boom. The boom might not be sustained, of course, because America's productivity is probably now too low for us to produce our way out of the Debt crisis. Writing in *Let's Talk Silver & Gold*, Jim Sibbet lists the following sequence of events and signs to help identify the turning point when our current recession will end and the crack-up boom begin. Some of these economic signals have already occurred, but the others will wait for any abolition of the holding period before materializing. Sibbet names them in chronological order as follows:

"First, interest rates come falling down with the Fed Funds leading the way, closely followed by T-bills. Then the Prime rate, and long-term bonds. Mortgage rates fall last. As they are falling the utility and preferred stocks go up, because they are interest-rate sensitive. A little later, the rest of the stock market joins them, in spite of continuing earnings decline."

Even more important than the profits that can be made by those who understand this game plan, the boom would buy us time to replace radicals in Congress with movement Conservatives and make the real changes necessary to establish prosperity on a realistic and permanent basis. As the Chinese say, there is opportunity in every crisis. ■ ■