

“Contract With America:” It’s Government Stupid

The winds of change are blowing across the world with gale force. New political and economic freedoms across the globe are the inevitable impulse of the reduced threat resulting from the end of the Cold War and the collapse of the Soviet Union. Absent these external threats to the security of sovereign nations, priorities and tolerances change. The policies of strong central governments not only become intrusive and meddlesome, but they are no longer being tolerated by the people. As external threat diminishes, the virtues of altruism and solidarity, for the nation and the motherland for example, are replaced. They are replaced with virtues that are less tribal, more associated with the Hayek’s notion of the extended order. These are virtues of cooperation, property rights and freedom of the individual to trade. The world is drifting toward a reduction of the power of the state relative to the individual, toward enhanced freedom, individual action and commerce.

The “Contract with America,” the recent Republican policy initiatives, is an as example of the changes that are occurring globally. This short paper explores some of the consequences of these forces on global rates of growth, rates of return on capital and free trade. As further background we look at global demographic trends and social security. Finally, through a review of the “Contract With America,” we will explore how these forces may affect domestic politics, the US economy and the US financial markets.

Rising Rates of Return on Capital and Free Trade

As more regions of the globe move from unfree to free, from planned to unplanned, economic growth rates will continue to increase. This will continue to be correlated with increasing rates of return on capital. The economies of Hong Kong and Singapore, the most open economies in the world, grew by over 5% per year during the 1980s. Countries that follow economically “free” policies, such as Taiwan, South Korea, Chile and Mexico, are among the wealthiest or fastest growing economies in the world.

Free trade will increase rates of return on capital and decrease returns to unskilled labor in the US. Through competition with Asia, which now accounts for 25% of global GDP, free trade will require the gradual elimination of the Western European and US social welfare systems.

Demographics and US Social Security

In the US, political power has passed to the baby boom generation. This has produced a realignment of Congress and a shift toward a highly educated generation that is just now

looking toward retirement, beginning to save and beginning to demand high rates of return on capital.

Domestic policies must now realign with the worldwide trend in population demographics. With advances in medicine and standards of living, the world's populations is aging. Since the beginning of the century, the number of people over the age of 65 has increased from less than 1 percent of the population to 6.2 percent. By the middle of the next century, this figure will surge to 20-25%, or 2.5 billion people. In the United States, and elsewhere, this has dramatic consequences for our age-entitlement programs.

Social Security is a transfer payment which could only be afforded when retirees were only the top of the population pyramid. As a particular age cohort looks to insure themselves against living past 65, members of the cohort can only count on receiving adequate insurance if only a small percentage of the population lives past this age. Insurance is a bet that the event insured against will only occur to a few, not to many. You can't insure against something that's likely to happen a large part of the population. Therefore, to maintain Social Security as an insurance program we must raise the retirement age until most people don't reach it. We also expect to see privatization of the entire Social Security system.

“Contract With America”

We disagree with the popular interpretation of the Republican sweep of the House, Senate and Governorships in recent elections. We do not see it as a result of a communication failure. We think our citizens do understand the policies of our government. Nor do we agree with those who think of the election results as merely a groundswell of public support to move the policy mix to the right.

Either of these two interpretations leads us to miss the real issue: The country is not merely moving to the right, it is moving *away from elitism* - from the strong central government needed to fight W.W.II and the Cold War - and *toward populism*.

Jeff Bell, in his book *Populism and Elitism, Politics in the Age of Equality*, gives us a much better framework than that given by our traditional left-right, liberal-conservative, Democrat vs. Republican spectrums. He proposes an additional dimension - a spectrum with elitism on one end and populism on the other.

According to Bell, populists trust people and trust markets. Populists don't believe, for example, that voters vote the wrong way. They don't believe that that an intellectual elite “knows best.” And, most importantly, populists don't believe that Washington “knows best” how to solve local problems.

The Republican “Contract With America” is a proposal for reducing the intrusive power of the state and a fundamental move toward the extended order, away from a society

whose cohesion is based on a shared external threat. The Contract With America may not in all cases be good economics, but it captures the electorate's insistence on a smaller, less intrusive Federal Government. It is a populist document, a radical move to limit the power of government and increase the power of the individual citizen.

The Contract can best be understood as a shift in the terms of the debate about the role and scope of government. It is not a finished product, rather it offers a new way of thinking about the debate. We anticipate the 1996 election to be like the 1980 election, an election about ideas and policies. For example, we expect a debate over Dick Arme's 17% flat tax, or even Bill Archer's proposal to eliminate all income taxes and replace them with consumption taxes. These are anti-elitist, populist notions. They cannot be well represented in our traditional paradigm of the conservative vs. liberal spectrum.

Overall, the direction of these policies will increase economic growth, reduce economic cycles, and produce a higher market multiple. Quality growth companies will benefit. Future growth will increase, but we still anticipate a 1996 recession, especially if tax rate reductions are phased in or are implemented after 1996.

For understanding the specifics of the Contract, we are going to return to the metaphor we used a year ago in "The Economy Game" January, 1994.

"In a game there are players and they play according to certain rules. Governing bodies establish and occasionally revise these rules. There may be referees who judge whether players have violated the rules, and award points when players score.

In the economy game the players are producers/consumers. They coordinate with each other to engage in transactions. In a typical transaction, a player exchanges his labor for money. He makes this exchange in order to purchase things for his own consumption.

There are five categories of rules in the economy game: tax, trade, monetary foreign and regulatory policy. Governments define these rules. Empowered by governments to act as referees are the courts, which interpret the rules. Other institutions also have important roles in specifying the parameters of the game, such as central banks, which maintain monetary standards and provide many of the instruments of commerce. These forces and the players interact to determine the course of the game.

When governments change their policies, for example, through trade agreements, they change the rules of the game. As these changes occur, players modify their behavior to conform to the revised rules; they also exploit anomalies that occur as a consequence of new rules, new technology, or new practices.

The natural tendency of the economy is to grow, and strong economic growth is the goal of the economy game. Government policies design to produce outcomes different from those created by the market interfere with this natural tendency. These interventions adversely affect the growth rate and the pattern of outcomes in the economy game.

If we understand the economy as a game requiring coordination with other players, then we can see that increases in tax rates, tariffs, regulations, inflation or increases in interest rates interfere with coordination and inhibit transactions essential to healthy play of the game."

The Contract With America addresses two of these areas: taxes, along with spending, and regulation. It is incomplete, in our view, in that it does not deal with monetary, trade or foreign policy.

TAX POLICY

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As former President Kennedy reminds us:

Tax reduction thus sets off a process that can bring gains for everyone, gains won by marshaling resources that would otherwise stand idle - workers without jobs and farm and factory capacity without markets. Yet many taxpayers seemed prepared to deny the nation the fruits of tax reduction because they question the financial soundness of reducing taxes when the federal budget is already in deficit. Let me make clearly why, in today's economy, fiscal prudence and responsibility all for tax reduction even if it temporarily enlarged the federal deficit - why reducing taxes is the best way to open to us to increased revenues. **FOOTNOTE????**

Tax rate cuts will result in higher rates of growth. This is because when we reduce the tax spread we increase the capacity of participants to play in the economy game.

Following are the tax proposals in the Contract, and their likely investment implications:

Capital gains tax cut will exclude 50% of capital gains from taxation. The top capital gains tax rate will thus fall to 19.8% for those in the 39.6% tax bracket. In addition, capital gains will be indexed for inflation prospectively.

A reduction in the capital gains tax rate is associated with small cap stocks outperforming large cap stocks. This is because more of their returns are provided in the form of the now lower taxed capital gains, and less in the now relatively higher taxed dividends.

Prospective indexation of capital gains, however, will benefit the stocks of those companies that generate capital gains slightly above the rate of inflation over long periods of time, relative to the stocks of those companies that generate large capital gains over a very short amount of time. High quality growth stocks should be a major beneficiary of this provision.

Higher growth rates will be more valued than lower growth rates. We can anticipate an expansion of high quality growth stock's relative p/es as a consequence

Requiring three-fifths majority to pass a tax reduces the chances of future tax rate increases on both corporations and employees. Such a change reduces the chances of recessions induced by tax increases and the chances of a reduction in future profits and cash flows because of a corporate tax increase.

Overall, requiring a three-fifths majority to pass a tax increase reduces the risk to capital in the United States, leading to some increase in the market multiple. The increase in P/E will tend to be more noticeable for companies with long horizons, that is small companies with their growth out ahead of them, and growth companies where the market is discounting earnings over a five or ten year horizon. This change will have less of an affect on companies where earnings are highly variable and horizons are quite short.

Neutral cost recovery of capital equipment will increase the amount of capital investment that can be expensed to \$25,000 from \$17,500 by small business, making it easier to deduct expenses associated with home-offices, and insuring that the total amount of deduction for capital equipment will equal its inflation adjusted cost. This is good news for sellers of capital equipment, including personal computers and other office products. Cash flows for capital intensive companies will increase, permitting the funding of expansion with internally generated funds..

The taxpayer debt paydown would permit taxpayers to designate up to 10% of their income tax payments to a reduction of the national debt, with a concurrent mandate that Congress reduce spending by a like amount. This may sound silly, but it represents a massive shift in power from the beltway politicians to taxpayers weighted by the amount of the tax paid. Effectively, this would permit a national referendum each and every April on the level of government spending. Any taxpayer could reduce Federal spending by up to ten percent of his or her tax payment by simply checking a box on their respective tax form. *This additional restraint on government spending reduces the risk to capital, reduces the risk of future tax increases and increases the chances of future tax rate reductions, suggesting a modest increase in the market multiple.*

Reform of the marriage penalty is a reduction in marginal tax rates on families with two working spouses. Passage implies a reversal of the recent decline in second incomes among families. Such a reduction in the tax rate on the second income implies more women in the workforce.

The tax deductible IRA would shelter the investment income on contributions made to these accounts in after tax dollars. This is a tax cut on income from capital relative to income from labor. *Combined with the demographic affect of the aging of the baby boom into the capital accumulation phase of their life, passage of this bill would create a significant, incremental demand for financial services, especially mutual funds.*

The \$500 refundable child tax credit is a new transfer payment to families with incomes below \$200,000 a year and children below the age of 18. A tax credit is not a tax cut. A refundable tax credit is a “George McGovern demogrant” for children. Qualification for this payment requires having children. It does not lower marginal tax rates at all. In fact, like all transfer payments, it implies a tax increase on all incomes, including the incomes of those that have children, to support the spending program. *Passage of the child tax credit will slow economic growth, and keep tax rates higher than they otherwise would have been.*

Reduce effective tax rates on Social Security recipients by raising the earnings limit and repealing the 1993 tax hikes on Social Security benefits. This reduction on income tax rates on individuals 65 and older will lead to an increase in their participation in the labor force. This is positive for people over 65 who want to work, and for their employers.

SPENDING POLICY

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We say that government spending nearly always reduces the size of the economy. Our thinking on this point is completely contrary to traditional Keynesian economic analysis.

Government spending, especially transfer payment spending, doesn't produce goods that can be used in the economy. In fact, transfer payment programs stipulate that people not work. For example, our welfare system compels people to not work in order to receive benefits. Only in those rare instances involving highways or airports, which actually increase our collective capacity to coordinate, do we see government spending growing the economy.

The line item veto, the one-third reduction in House committee staffs, the audit of the House finances, and Welfare reform are all aimed at reducing spending. The Balanced Budget Amendment is the most visible of the efforts to reduce projected spending. According to this Amendment, the budget would have to be balanced by the year 2002.

Other specifics of the program include:

Medicine: Government spending on medical care is going to be less than expected. Medicare and Medicaid are due to be reformed, now that National Health Insurance (Medicaid for all) is off the table. One possibility is that Medicaid patients, the majority of which still get fee for service medicine, will be shifted into managed care: i.e. HMOs.

Agriculture: Many companies and sole proprietors (farmers) are dependent either directly or indirectly on government largess and/or subsidies. The many rules under which the entire US agriculture sector operates may be rewritten. Currently, in exchange for receiving farm supports, farmers must take land out of cultivation. That is, they get paid for doing nothing with their assets. What happens if farm supports decline and the amount of acreage under cultivation goes up? Prices will decrease and exports will increase.

Defense: President Clinton's request for a \$25 billion increase in defense spending signals that the worst of the defense cuts are behind us. But Defense Secretary Perry's call for eliminating funding for some major new weapons systems suggests that the adjustment process is far from over.

REGULATORY POLICY

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Regulations are rules of the game. They define what we can, must and cannot do. Reductions in regulations will expand the play of the game and grow the economy.

All laws that apply to the country will be applied to Congress. This includes the Civil Rights acts, the American with Disabilities Act, and the minimum wage. Federal agencies will be required to complete a regulatory analysis when drafting a major rule, including a demonstration that the rule is cost effective, and private property owners are to receive up to 10% of the fair market value of their property from the Federal government for any reduction in the value of their property.

A reduction in the regulatory burden is equivalent to a tax cut, but it will fall on different industries disproportionately. Some will be helped, because they can shed costs. And others will suddenly face new competition that had been held at bay by regulatory hurdles. Generally, we can expect implementation of this act to lead to a stronger economy, higher corporate profits, and more competition.

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