LIBERALS MUST FACE THE FACTS
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INTERVIEW | ALFRED E. KAHN

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Q. The supply-side economic policy now being pursued by this administration appears to negate the liberal programs and objectives that dominated the national scene for decades. Is this because liberal ideals are bankrupt, or because a drastically changing economic environment makes past programs irrelevant?
A. I can't believe that it was a bankruptcy of liberal ideals or objectives. I think, rather, that it was the bankruptcy of liberal programs and perhaps intelligence. I don't think the American people really voted to retreat from the goals of the New Deal and the Fair Deal, or to abandon environmental protection, for example, or the provision of information for consumers, or safety on the job. The American people, in general, continue to believe they can retain the social and economic gains of the last forty years but do it more efficiently. That is how I interpret the political change.

Q. What caused the upheaval?
A. Clearly it was inflation. That demonstrates two things: one is how profoundly significant inflation itself is and, two, how damaging it can be to our society. Inflation not only seems to slow down productivity growth, but it also seems to bring on recession. Even more important, inflation is socially divisive: it erodes our social contract; it weakens our social fabric. Inflation is a profoundly social and political phenomenon and not strictly an economic one, except superficially.

Q. Is the failure of the liberals to come to grips with inflation in the 1970s rooted in a lack of understanding of the social and political behavior contributing to inflation?
A. That's not a shortcoming of liberals alone. Rather, the liberals have failed in the past to see the necessity of redefining their programs to make them consistent with the economics of scarcity. They have devoted much too much of their energies in the past to promoting the competitive scramble for income shares. Liberals have been much too hesitant to admit that a labor union can do wrong. There is something that still offends them in saying,

"... inflation is very divisive: it erodes our social contract. . . ."

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"Liberals must develop policies that are more compatible with our new problems of scarcity."

"You know, the automobile workers have really been screwing the rest of us, including their own unemployed," because the UAW is a good union and Doug Fraser is an enlightened union leader.

Q. How have they been "screwing the rest of us"?
A. By having automobile wages increase twice as much as average wages in the last decade, and by sitting by while that was simply translated into higher and higher prices of poor-quality cars. The automobile workers who have retained their jobs have been exploiting those who have lost their jobs, who are now losing their homes in Detroit and being forced to uproot themselves and move down to Houston. In effect, the auto workers are also exploiting the ladies' garment workers and others who have been getting wage increases lower than the national average. Liberals should consider the exploitation of market power just as offensive when wielded by unions as by industry, even when those unions are well-run, not corrupt, not featherbedding.

Liberals have revealed blind spots in their analysis of other economic problems as well—regulation of oil and gas prices, for example. They have a spotty record in applying rational analysis to achieving liberal goals, consistent with an economic environment of shortage, scarcity, and inflation. To cite my own record, I was the architect of the system of regulating the price of natural gas. By developing the two-price system back in the late fifties, I probably helped save consumers billions of dollars, by holding down royalty income and the rents that would otherwise have been earned by the oil industry. But to the extent that I get credit for that policy, I have to take blame for the distortions created in the pricing of natural gas, the over-rapid consumption of our natural gas resources, and for all the problems that arise from a price below marginal costs. There was a fuzziness in the analysis of that policy's distributional impact and its effects on economic efficiency, particularly as the country moved into an era of energy shortage and persistent inflation. Yet some liberals continue fuzzily to advocate regulation of the price of crude oil and gas.

Q. How do we get liberals to adapt their goals and policies to the new economics of scarcity?
A. Nothing so marvelously concentrates the mind as losing elections, to paraphrase Samuel Johnson. Ronald Reagan's administration and the political losses it has forced upon liberals are certainly going to have a fine educational effect. Whether it will be sufficient to turn around the traditional constituencies of the Democratic party, I am not at all sure. I don't know if liberals can rise above the shibboleths of their constituents even when they themselves understand the problems. But if we can't learn from our failures, then I am terribly worried about our country as well. Liberals must develop policies that are more compatible with our new problems of scarcity. There is a need for some restriction on federal transfer programs and for leaning more toward efficiency and incentives and less toward redistribution. This is a dilemma that Arthur Okun talked about six or seven years ago. If this can be done only by the likes of Ronald Reagan, then our country may be in serious trouble, because he may do it in ways that almost totally dissolve the social contract. His methods may alienate large groups in our society, and flout our conceptions of social justice and equity. It is not necessary for America to give up its liberal ideals in order to combat inflation and solve its energy problems. A liberal political movement can be both compassionate and rational, idealistic in its goals and hardheadedly realistic in the means it adopts to achieve them. That is the task for liberals in the 1980s—to reconcile our traditional aspirations with economic efficiency, humanitarianism with the control of inflation. In the short run, it means being more selective about the kinds of programs we support and the way we identify their intended beneficiaries. In the longer run, however, it offers the promise of a resumption of economic growth, and continued progress in humanizing our society, for which growth is the prerequisite. If instead we take refuge in the slogans and programs of twenty to fifty years ago, and fail therefore to cope with the economics of scarcity, we will not deserve to govern.

Q. Let's look at the social-political process that feeds the wage-price spiral. What prospects do you see far ahead for a United States incomes policy?

A. We will have to deal more directly with the built-in wage-price mechanism and the wage-wage spiral. I was impressed with the fact that in the spring of 1981, coal miners turned down a three-year 36 percent wage increase at a time when the nation's productivity was going up by zero. The miners were chasing the automobile workers, who got what looked like an 11 percent wage increase last year, but it actually turns out higher because of their cost-of-living adjustment. I should note that the auto workers marched to the teamsters' settlement of the preceding year. The teamsters were marching to what the coal miners and railway workers got the year before that. So this built-in wage-wage spiral, as well as the wage-CPI spiral, is entrenched in our institutional arrangements for wage bargaining and the struggle to divide the national income pie. I fear it is so powerful that we will have to confront it directly in order to mitigate the collision between macroeconomic restraint and self-generating price increases. This collision not only threatens recession. It poses a grave political question which Margaret Thatcher is already facing, about how long democracy can endure these economic costs before seeking a means to bring the destructive inflationary spiral to an end.

Q. But how do we do just that?

A. It doesn't have to be mandatory wage and price controls. Since I have had the frustrating experience of trying to administer a wage-price standard system, I want to emphasize that the main defect of that system was not, in my judgment, that it was voluntary and, therefore, weaker than a mandatory system. Setting fixed standards—voluntary, mandatory, or somewhere in between—is just not a workable way of attacking inflation in the long run. That is why I find TIPs so much more attractive. But you have to supplement such incomes policies, particularly with disciplines on consumption. Therefore, I think liberals should press for value-added taxes or VAT (taxes imposed on the price of products at the time of sale), coupled with a lump sum negative income tax, to correct for adverse effects on income distribution. Here you might find allies among conservatives, since Milton Friedman, after all, is a prime exponent of the negative income tax. Let's clearly recognize that it is not illiberal to have taxes on consumption.

Q. But doesn't the VAT actually give impetus to the rise in the consumer price index, as Britain discovered in the summer of 1980 when it increased the VAT?

A. Well, that brings me back to the question about how a society achieves a consensus for self-discipline. If we reduce income taxes and raise value-added taxes correspondingly so that taxes on balance are no higher, and at the same time compensate for adverse income-distributional effects through a negative income tax, then there is no reason why any incomes need be indexed to compensate for the once-and-for-all jump in the CPI. That does not mean some groups will not try. The debate over indexation to recover the rise in the CPI is part of the struggle for income shares.

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I don't think the comprehensive program we need could be achieved easily, given the political constraints in a democratic society. Unfortunately, to reach the necessary consensus we may have to get to the point where the situation becomes intolerable. I recall my own experience with President Carter's real wage insurance proposal. That had the minor defect of being opposed by labor, opposed by business, and supported by only a few academicians. But we will have to move eventually in the direction of an incomes policy. Indeed, maybe President Reagan's toughness in the air controllers' strike is his first step toward such a policy. But I want to stress that liberals should be advocating a variety of policies to introduce together—TIPs to give people incentives to restrain wage settlements; the VAT to restrain consumption; limits on the deductibility of mortgage interest—a clearly illiberal provision, that helps middle and upper-income people much more than the poor—along with the unlimited deductibility of high living on business expense accounts. These measures should be supplemented by various policies to encourage investment. Liberals ought to be the strongest proponents of a competitive market, but I don't know if they can push for the free market with their constituencies. Even Reagan is caving in. He is placating the teamsters (and trucking companies) by reversing deregulation of trucking; placating the United Automobile Workers (and auto manufacturers) by putting pressures on the Japanese to restrict imports of Japanese cars; placating the textile workers as well as the textile interests, by advocating tightening the multilateral fiber agreement.

Q. You see an inconsistency among liberals between policies to create more competition and freer markets—whether international or domestic—and measures to protect those workers and consumers who are vulnerable to the ravages of the marketplace. Can these two positions be reconciled?

A. The inconsistency in fact involves three problem areas. One is the espousal of competition, the second is advocacy of protection for people who may be subjected to painful adjustments resulting from the operation of free markets. The third has to do with the constituencies of liberal politicians—automobile workers, textile workers and farmers. Remember, "farmers" include the 15,000 farmers who grow sugar—less than one percent of the group—the tobacco farmers, and the peanut growers, all three of whom Reagan has already moved to placate in ways that should be objectionable to believers in competition. I can in principle resolve the inconsistency you describe more readily than I can solve the last problem. Clearly, you want to help people in trouble, but not by protecting them permanently from competition. You should help them in the transition with unemployment insurance, relocation, and retraining assistance. These measures reconcile the liberal espousal of competitive markets and dynamic change in the economy with their belief in helping people in times of painful transition. I don't know how to solve the third, political problem, except to hope that Lane Kirkland, exposed to Ronald Reagan, may come to realize that Jimmy Carter wasn't such a bad guy after all. We should understand that liberals may continue to have Ronald Reagans to deal with unless we devise a social arrangement that includes wage restraint as an important component. Lane Kirkland was not even able to contemplate that as a political position, even if he could consider it intellectually.

Q. From your experience dealing with the Congress and the Carter administration, what insights do you have about moving toward such a trade-off?

A. There was no discipline for me more sobering and effective than the discipline of having inflation move to the 18-to-20 percent range in the first quarter of 1980. At that point we had an extraordinary eight full days of meetings, involving the President's principal economic advisors and all the leaders of Congress. We all brought our lunch bags—Senator Muskie, who headed the Budget Committee, Senator Byrd, and Jim Wright, all the Congressional leadership. We had unanimous agreement to come in with a balanced budget. Yet, at the end of those intensive discussions, we managed to discover only $15 billion in budget cuts that we could agree were politically achievable. Even though I have strong criticisms of the way in which he has distributed them, I believe the larger Reagan cuts are necessary, but not, as the President proclaims, because the government is the source of all inflation—that is garbage. Government expenditures in the United States as a percentage of our gross national product are modest compared with other countries like Germany, which has had much more success than we in containing inflation. During 1979, for example, net debt in this country increased $370 billion and of that increase only $55 billion or 20 percent was government debt at the state, local, and federal levels. There is nothing in economics or logic that says that the $55 billion of spending beyond income by the government was somehow the sole source of inflation, whereas the $110 billion of outlays for homes financed by the net increase in residential mortgage debt had nothing to do with it.

Q. Your example described intensive budget discussions between Congressional leadership and the administration. Shouldn't labor and business be brought into such discussions earlier in some kind of tripartite arrangement?

A. There was genuine effort to draw business and labor into that process. There were these lengthy conversations all through the late spring, summer, and fall of 1979 eventuating in a so-called national accord, setting up a pay advisory committee and a

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price advisory committee. But those arrangements failed.

Q. Why?
A. Primarily because they were inevitably mixed in with the achievement of political support for President Carter, with the election only a year away. But also there was no real willingness or ability to give, particularly on the part of labor, and the business people really wanted to scrap the pay and price standards, while being unwilling even to think about putting some other incomes policy in their place.

Q. But hasn't that changed now? Labor has shown some willingness to give in the Chrysler situation.
A. Observe, however, two things. First, when Chrysler was already clearly going to the wall, the UAW achieved what looked like a 33 percent wage increase over three years, probably even higher because of the COLA clause. Second, after all the negotiations about the Chrysler loan, labor acceded to concessions of something like $240 million in wage postponements. Yet, the costs to Chrysler in the three-year settlement were $1.5 billion. That small concession was outrageous.

Q. Outrageous, how? How do you mean?
A. In two ways. The union and Chrysler came to the government for $1.5 billion in loan guarantees while at the same time actually breaking the administration's wage standard. Then labor's contribution was so small, especially when you realize that the automobile workers are the elite among organized labor in terms of earnings as compared to the average industrial worker. Of course, I was excoriated by the labor people when I pointed this out publicly. In any case, Senator Proxmire was prompted to call back the bill and get labor's contribution hiked to $480 million. Then as Chrysler's situation worsened, the UAW did give up something like a billion. That resolution can be regarded as heartening. Or was it disheartening because it took so extreme a crisis to elicit it? Yet labor, so far as I know, has never made a single concession to General Motors or Ford even to this day. They have instead concentrated on closing off Japanese imports. So, as I say, there is a sign of some give in the auto case; the question is whether it is even close to sufficient. You see similar signs in other cases: Conrail workers have made concessions. Firestone and Uniroyal, again, after being driven to the wall, obtained some labor concessions. So did Braniff and Pan Am. But notice that in each case the companies were just about at the end of their tether. It seems to take this state of crisis to induce labor concessions. That doesn't make me sanguine about the prospects for business, labor, and government sitting down and devising some genuinely rational and restraining incomes policy. Ronald Reagan's presence makes it harder because many of the business people will be inclined to say, we don't need an incomes policy any more, we're getting macroeconomic restraint, and that will suffice to restrain wages. But the prospect of massive job losses in key industries may make labor more willing to consider wage restraints. As the next two years unfold, there is the possibility that labor and the other traditional constituencies of the Democratic party will come back with a program that is more likely to appeal to the great majority of the American people, who are worried about inflation and unemployment. I realize I don't offer you much hope, however.

Q. Most critical in your mind, then, is how we tackle the problem of resolving conflicts of economic power that eventually determine the struggle over wages and income shares. But why have you focused only on the labor side?
A. Primarily because I am directing my message to liberals, who have been unwilling ever to criticize labor. I believe I am as strong a critic of business monopoly and sluggish and megalomanic company managements as I ever was. There is a vestige of traditional liberal in me that makes me uncomfortable about focusing solely on the economic power of labor. Nevertheless, that vestige conflicts with my perception as an economist that 75 percent of our national income comes from wages and salaries. Therefore, to the extent that we are concerned about an upward pressure in demands for income shares, we have to concentrate on what determines those wages and salaries. The institu-

tional process that generates the wage-price, wage-wage pressure is rooted in organized labor and the ability to increase wages far more than national average productivity. There are certainly other ways in which inflationary pressure is exerted—for example, in the demand for tax breaks and deductions, loan guarantees, cheap credit, and government expenditure programs. We can attack those separately and in ways that I believe are consistent with liberal values and my sense of distributional equity. So, with all that elaborate apology for looking at the labor union problem, my question is, how do we retain the virtues of unions exemplified by Solidarity in Poland—those things that we believe unions do that are wonderful—while getting wage restraint on the part of the most powerful among them? The arithmetic is irrefutable: we cannot have lower interest rates, a more expansionary and humane fiscal policy and a resumption of economic growth unless and until we find a way of restraining wages.

"... how do we prevent a comprehensive industrial policy for the United States from drifting into a syndicalization of the American economy...?"

Q. Couldn't the political stalemate be overcome in part by the operation of competitive markets?

A. There is no doubt we need a more resolute policy of market competition. The best limitation on the ability of the truckers to earn monopoly profits and of the teamsters to get wage increases far above the national average—very similar to the UAW and the steel workers—is competition in those industries. That has already been demonstrated in the deregulation of airlines. The pressure of competition limits the ability of strong labor organizations to carry out tacit collusion with oligopolistic or cartelized industry, which then passes off wage increases, along with a comfortable profit margin, in higher prices. Notice that the cases I have pointed to, in which competition is in some degree a limit on excessive wage increases and price increases, are cases in which international competition was the effective restraint. Despite the existence of multinationals, the Japanese car imports were an effective competitive limit, though maybe not sufficiently effective, on the continued exploitation of the market by the UAW and the automobile companies. In the case of airline and trucking regulations, it wasn't big business but the government itself that was stepping in to cartelize these markets.

Certainly when I look at price supports for sugar, peanuts, and tobacco; the regulation of trucking, communications, and airlines; and restrictions on the imports of textiles and cars, I see a whole series of ways in which government action interfered with competition whenever it threatened to discipline income demands. Liberals ought to speak for the interest of society at large against the pressures of the special interests, no matter what their label; needless to say, that includes businesses that are insufficiently subject to the discipline of competition.

Q. Let's assume that we can free competitive markets. Then how do we approach the other side of the issue? How are you going to help workers and industries adapt to this new competition and survive the agony of adjustment?

A. I did not object in principle even to the Chrysler bailout. Where the social disruption from unrestricted exposure to competition is sufficiently injurious, I am not a purist, saying, "Government, hands off, no matter what the cost." What I do say, however, is that the ways in which the government tries to help people, communities, and regions in really deep trouble ought to be minimally obstructive of competition. In other words, if I had to choose between putting restrictions on imports of Japanese cars and having loan guarantees for Chrysler, I would choose the second *always*. If the government's going to intervene, I would also insist on the maximum concessions from the direct beneficiaries. Second, and following the same principle, I tend to oppose rather strongly Felix Rohatyn's RFCs as an instrument of industrial policy, because I see them as giving massive infusions of capital and protection to losers rather than winners. But I do not object to the use of tax incentives, neutrally as between industries, to attract investment in depressed areas. I support the Economic Development Administration, for example, and I favored President Carter's August 1980 tax proposals, which included a special investment tax credit for areas where unemployment was well above the national average. Similar programs can combat the progressive and cumulative decay of industry, public infrastructure and institutions, and public services.

Q. You have warned against a greatly increased "danger of protectionism and cartelization" and have voiced fears about where a tripartite arrangement among government, business, and labor might lead us. Exactly what do you mean? The nation may be moving toward such an arrangement in the 1980s.

A. I think it terribly important to regain some cooperative recognition on the part of labor—not just union people—and business management, of the importance to our country of the commitment to productivity and technological advance. There is nothing in history that tells us we will necessarily escape the historical decline of Britain, or the Dutch before them, or the Spanish or the Venetians before them, in terms of losing technological leadership. But I think that's a very important part of our solution, if we are to have a solution. That means also, by the way, a shared interest in the quality of products. American cars need not have a repair record three times as bad as Japanese cars. We need collaborative efforts by labor and management to advance along a broad front on productivity improvement. The kinds of solutions we develop to raise productivity, improve production methods and product quality, and promote technological progress should not restrict the market. The most visible outcome of the tripartite discussions that took place in 1980 about the steel industry was a tightening of the trigger price system. In the great depression of the thirties our first dramatic economic recovery program was the NRA, which was essentially an attempt to force cartels on the whole economy, setting prices, limiting output, and so on. When I read about what happened to Germany in the 1920s I was struck by how comprehensive a syndicalization of the whole German economy took place at that time. Italy followed the same path. One of the few correct things Reagan said in the campaign was that the NRA really was patterned after fascism in Italy—I don't mean its political philosophy, but its economic programs. The question is, how do we prevent a comprehensive industrial policy for the United States from drifting into a syndicalization of the American economy and all the rigidities that entails? We have to be ready to scream loudly whenever such tripartite boards or committees are set up, so that people who are selected are very conscious of the values of competition. I pressed President Carter in such cases to appoint as public representatives people like Archibald Cox, the assistant attorneys general in charge of anti-trust, individuals with Common Cause interests who would be sensitive to both the productive possibilities of this kind of arrangement and its dangers. We could just as easily end up with a new act for regulating motor carriers or airlines or any other industry because it is in the interest of labor and management on the inside to cartelize those markets. That's just the opposite of what I think we need.

Q. Wouldn't the average person be more agreeable to a social contract with restraints on demands for income shares if he saw more effective restraints on the power of huge conglomerate enterprises? For example, what about the concentration of corporate profits of the oil companies, profits which were squeezed from consumers of gasoline and heating oil?
A. Of course. I am as angered as most liberals by the huge profits oil companies have been earning. Even though most of the dollars have gone into an enormous increase in exploration for new petroleum reserves and investment in alternative energy sources, many have gone to socially far more questionable uses. In testimony before the Rodino Committee this summer, I referred to Exxon's much-advertised acquisition of Reliance Electric, which turned out to be a failure. There are serious grounds for questioning, similarly, how Socony's acquisition of Marcor and Dupont's purchase of Conoco will contribute to the nation's economic efficiency. Years ago I had students writing papers on the New York Central-Penn Railroad merger. They were all convinced by the assertions of the active parties in that case that it would produce huge economies. It was to be the greatest thing since jelly beans. Well, as we know, it turned out to be a terrible mess.

I have at least two other reactions to your question. One possible social arrangement that might bridge the gap between the man in the street and the power of the oil companies was the Carter administration's windfall profits tax, coupled with the deregulation of crude oil prices. Some of the proceeds from windfall profits were used selectively to help low-income people cope with skyrocketing energy costs. I am ready to support deregulation of gas prices provided it is similarly accompanied by a big fat windfall profits tax. My second reaction is a realization that such a solution will never be acceptable to all people, because it must always be a pragmatic political compromise. Congress exempted from the windfall profits tax all the royalty owners, and hundreds—maybe thousands—of small millionaires; in this rush to exempt, the Democrats were just as bad as the Republicans. Therefore, some liberals will always be able to say, "We haven't succeeded: oil companies are still getting excessive profits. There's still injustice." But there are always going to be residual injustices. The question is whether we can achieve reasonable compromises. One of the obstacles to that is a lack of understanding: most Americans do not realize, for example, that total corporate profits after tax amount to only about 5 percent of our gross national product.

Q. What about the distribution of profits?
A. Sure, it's uneven. When certain resources become scarce, their prices will go up, and that will generate windfall profits. We ought to tax such profits to the extent we can. But we should look at that situation in the larger context of a national problem of persistent inflation and zero productivity growth. Let me illustrate what I mean: in the United States, with a GNP approaching \$3 trillion, each year you would normally expect productivity growth to raise our GNP about \$90 billion—about 3 percent. Well, after tax, corporate profits are not much larger—4 to 5 percent of GNP. Now suppose that one-third of those profits are excessive by your definition and mine: then this problem of excess profits has a magnitude comparable to only one-third of a single normal year's increase in productivity, to which those profits surely make some contribution. All I am trying to say is that we must not permit an emotional distrust of profits to interfere with our struggle against stagflation, and in particular with our national effort to promote productivity, which is so important to that struggle and to the achievement of liberal goals.

Traditional liberalism has achieved its greatest triumphs by marrying the quest for social justice with the promotion of economic growth. We cannot, by neglecting the second of these, afford to entrust our national destinies to people who seem not to care at all about the first.