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Abstract: Discusses the reaction of the markets to the Republican takeover of Congress. Comments on the views of James Madison in the 'Federalist Papers' about special interest groups; Evidence that government has grown under both Democratic and Republican administrations; Government regulation.

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In reacting coolly to the Republican sweep, the markets are recognizing the validity of what James Madison wrote nearly two centuries ago in the Federalist Papers.

HOPE VERSUS MEMORY

THE REPUBLICAN takeover of Congress has excited advocates of smaller government. Even President Clinton has changed his tune: Small government is beautiful.

I remain a skeptic. As James Madison pointed out in the Federalist Papers, No. 10, the Achilles' heel of democracies is their special interest groups. In 1787 Madison worried that these groups would prevail in a popular democracy because the benefits they receive from the government are concentrated, while the costs they impose on the taxpayers are diffuse. Alas, Madison's theory has proven to be correct. Even though politicians of both parties rarely campaign for higher taxes, more government and increased rules and regulations -- that's usually what they deliver. It's what the special interest groups demand.

Set aside for a moment the rhetoric about reducing the size and scope of government and look at the record. Compare Republican and Democratic administrations over the four decades since Eisenhower's first term. As the accompanying table shows, we have had only one kind of government, whether Republican or Democrat in name -- the growing kind. Both parties have routinely increased spending (all figures computed in real 1987 dollars), raised taxes and promulgated more regulations.

The only exception to the growth in spending is in defense and international affairs. Contrary to conventional wisdom, the Democrats, with the exception of the Clinton

Administration, have been the big defense spenders. On the other hand, the Republicans, with the exception of both Reagan administrations, have actually cut spending in this category. The new Republican Congress promises to run counter to the Republican tradition and increase defense expenditures. Smaller government?

The Democrats and Republicans run almost neck and neck on the nondefense portion of the budget. This, no doubt, is because of entitlements -- education, health and welfare -- which make up almost 60% of the federal spending and are largely on automatic pilot. If history is a guide, we can forget a scaling down of government spending with the new Republican Congress.

It is true that corporate taxes have declined when Republicans have been in charge. Consequently, the new Congress will probably deliver on its pledges of lower taxes, especially lower capital gains taxes. These reductions will be capitalized, of course, into the value of shares, and that should give stocks, particularly the small-cap variety, a bit of a boost. Chalk that one up for the Republicans.

But let's look at regulation. A crude index of the regulatory reach of Washington is the page count of the Federal Register, which contains the new rules and regulations promulgated by the executive branch. Judging by this measure, perhaps a little relief is in sight, but not much. The Republicans are only slightly less ambitious than the Democrats when it comes to adding pages to the Federal Register.

For those of us who love and venerate liberty as a cat loves and venerates catnip, the Republican rhetoric soothes and pleases. Yet my memory of the inevitable gap between that rhetoric and the Republican reality leaves me gloomy and grumpy. Since World War II, the Republicans have done little to disprove James Madison's thesis about special interests working their will in democracies. Hope springs eternal, but experience counsels skepticism.

Big spenders vs. pretty big spenders

Democratic	Republican		
		%	%
Spending			
Defense and international affairs		9.72%	-6.11%
Total nondefense		25.54	18.98
Education, health and Social Security		26.03	24.16
Taxing			
Personal income tax		22.28	3.64
Corporate income tax		9.36	-6.43
Social Security tax		29.61	20.82
Pages added to Federal Register (a proxy for regulations)		31.37	21.31

Aggregate percentage changes (in 1987 dollars) for Democratic and Republican administrations since 1953.

PHOTO: Steve H. Hanke

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