

# Pathfinder

CENTER FOR EDUCATION AND RESEARCH IN FREE ENTERPRISE  
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## THE GENEVA MEETING COULD BE A MISTAKE

*At the time this article was written, the meeting in Geneva between Ronald Reagan and Mikhail Gorbachev had not yet taken place. In this article, we voiced our fears that the U.S. might weaken its defenses in exchange for Soviet "concessions." As you read this paper, you should be able to compare our presummit analysis with the most immediate postsummit events. We sincerely hope that our cost-benefit analysis of the summit was not right.*

On November 19-20, President Ronald Reagan and Soviet leader Mikhail Gorbachev will meet in Geneva, Switzerland. The issue before the American public is whether the U.S.A. will benefit by participating in the summit *at this time*. Conventional wisdom is that (1) current international relations, and (2) personalities of Reagan and Gorbachev, will determine the value of the summit. We believe the answer lies in the prevailing socioeconomic relations *within* the U.S.S.R. The Soviet government's choice of issues, positions it takes on those issues, and compromises it is willing to accept, depend on the internal situation in the Soviet Union.

Soviet leader Gorbachev is a formidable person. After a string of mediocre, humorless and risk-averse men, the new Soviet leader is a capable, engaging and enterprising fellow, probably the most capable Soviet leader since Stalin. American media have noticed the difference between Gorbachev and his predecessors. But they have not raised the right question: Is Gorbachev going to be able to circumvent the Soviet bureaucracy? We conjecture that Gorbachev is a product of the Soviet bureaucracy. *The bureaucracy* made him the country's top leader. Whatever Gorbachev's private opinion about the Soviet system might be, he has little incentive to change it.

Gorbachev has to deal with a power structure that includes four major institutions, which might have the same long-range objectives, but differ on the issue of tactics. Gorbachev's job is not unlike that of an orchestra conductor—he has to bring all four groups together; the bureaucracy is, however, the concertmaster.

The Red Army is an intensely patriotic, nationalistic and risk-averse force. Its officers have many privileges and enjoy a high standard of living (by Soviet standards). The Red Army is a *status quo* oriented institution that is not likely to push for social reforms.

The KGB (secret police) used to be the most powerful institution in Russia. Since 1954, its power has eroded. Today, the KGB's power is, at best, only equal to that of the Party bureaucracy. The KGB seems to have no philosophical position on social reforms. Whether the KGB supports any social reform in Russia would depend on its evaluation of the reform's potential impact on its power. The KGB also would object to social reforms that complicate its job. Thus, the KGB is not likely to trigger social changes in the U.S.S.R.

The Soviet manager has a well-defined job: the firm must produce at least the planned output. The manager's job security, promotions, income and other privileges depend on being alert to the Party's preferences. The Soviet manager is in the best position to see how the productive energies of the economy are being wasted. Moreover, he is constantly frustrated by red tape, incompetence and inflexibility of the Soviet bureaucracy. The Soviet manager sees institutional reform as a vehicle for increasing the effectiveness of the Soviet system. If the pressure for social change is to come from within the Soviet power structure, the Soviet manager will be the force behind it.

The Party bureaucracy runs the Soviet Union. It determines domestic and foreign objectives in the country and monitors their implementation. At the top of the bureaucracy is the Politburo, the most powerful body in the Party. The Politburo is a small, self-perpetuating group to which one is appointed through personal connections and from which one departs by death or in political disgrace. The Politburo runs the country *via* the Central Committee of the Communist Party, regional committees and a huge army of professional Party workers. The government bureaucracy (which is infiltrated and controlled by the Party)

*Continued on next page*



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From page one

is merely a vehicle for carrying out the Party's decisions. The size of the bureaucracy in the U.S.S.R. is truly staggering. The bureaucracy has the dominant role in choosing Soviet leaders. It is also powerful enough to replace leaders who threaten its leading role in the U.S.S.R. For example, in 1984, a Soviet historian, Ambracumov, wrote that some social problems in socialism could be traced to mistakes made by the Party bureaucracy. He was quickly criticized by a Party bureaucrat, Bugajev. All problems in socialism, Bugajev said, are caused by either the remnants of the old system, or military-industrial complexes in capitalist countries, or international financial cartels. To top it all, the Department of History of the Soviet Academy of Science met (on whose request?) to discuss the issue, and came out in support of bureaucrat Bugajev's position.

Gorbachev has identified the ruling elite's major concerns: arms control and the economy. The first issue will be the central theme of the Geneva summit. The second, the most important domestic problem in the Soviet Union, shapes that country's external behavior.

The Soviet economic performance, which has been changing from bad to worse, was described in an earlier issue of *Pathfinder* (June 1985).

The economy is like a football game. It could be improved by either changing the rules or better coaching (management). Gorbachev means the latter, while the American press assumes that he means the former. Gorbachev's self-interest lies in trying to improve the existing system of planning, and not in changing it. He has already commended the Czechs for working to improve the system and warned the Hungarians not to go too far in reforming theirs. At home, the new liquor law is a good example of Gorbachev's approach to social problems. Drinking, a major problem in the Soviet Union, has paralyzed the economy. For example, in a small village in White Russia, each month the village's 7,000 inhabitants of drinking age turn in 150,000 bottles for refunds. It comes to 21 bottles of liquor per person each month. Gorbachev would not address the causes of heavy drinking, such as boredom, economic hardship, emptiness of life and the apartheid of thoughts. And, he did not ask what kind of changes in the system would reduce those problems. Instead, he passed the law that raised the drinking age, limited liquor stores to five business hours, and imposed penalties for being drunk in public. The outcome of this law has been predictable: longer lines outside stores and lots of violations.

Gorbachev's second major concern is the arms race. He has two objectives: to lighten the burden of defense expenditures and to stop our

"star wars" project. Why? The Soviet bureaucracy requires military strength to pursue its political and ideological policies abroad. The Soviet military demands, at a minimum, power balance with the West. At the same time, defense spending is a heavy burden for the economy. Thus, a reduction in U.S. expenditures could lighten the burden without necessarily giving up the weapons parity. What Gorbachev needs, and has already proposed in preparation for the summit is an agreement on a limitation of weapons that *promises* to be militarily beneficial to both super-powers, but could easily turn out to be a one-sided concession to the U.S.S.R. This is not to say that Gorbachev is a liar, but there is no evidence that he is not. No Soviet leader could be accused of having kept promises made at conference tables.

The United States' "star wars" is the most bothersome problem for the Soviets. The Soviets have made it clear that they are willing to pay a high price, in terms of concessions that were nonnegotiable before, to induce us to reduce our commitment to the project. On July 1, *Pravda* wrote, and the same theme has been reiterated almost daily by the Soviet press, that the U.S. space-based defense shield aims to achieve both a first-strike capability and U.S. military superiority over the U.S.S.R. Moreover, the Soviets claim that *even* research on this program is completely destabilizing to the military balance of power and should be stopped immediately. Forget the whole thing, and we will make a lot of concessions.

The amount of Soviet shouting with respect to any issue is directly related to that issue's value to the West. The Soviet attitude toward "star wars" is evidence of its potential value to the West. Should the U.S. give up a weapon likely to give us an edge over an adversary whose explicit objective is to destroy our way of life? We think not.

The recent "concessions" of the Soviet Union are evidence of how much it wishes to stop "star wars." Why else the proposed reduction in nuclear weapons, the publication (albeit censored) of President Reagan's interview with Soviet journalists, and the talk of letting the Sakahovs go free—to influence world opinion.

So what do we gain by going to Geneva in two weeks from this writing? If we stick with "star wars," there will be no agreement, and the Soviets will gain a propaganda victory. If we negotiate "star wars" away, they will make a major step in neutralizing our potential military advantage.

—Steve Pejovich  
Charles Maurice

## U.S.A., U.S.S.R. AND THE MIDDLE EAST

*The subject matter in this article is quite controversial, yet we decided to publish it because the paper shows that the primary beneficiary of the present Middle East situation is the Soviet Union. Dr. A. Sullivan recently was in Dallas as a guest of the Dallas Council on World Affairs.*

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Few Americans perceive the contributions by Israel and the United States to the growth of Islamic fundamentalism, and to regional instability from which the U.S.S.R. may yet greatly benefit. In 1982, Israel invaded Lebanon with American foreknowledge and tacit support. No Arab or Muslim was unaware that bombs falling on Lebanon in 1982 were made in the U.S.A.

Israel's attempt—with American indulgence—to install the Maronite Phalangist party as ruler of Lebanon quickened the fundamentalist impulse. A basic cause of the Lebanese civil war was and is the Maronite refusal to make political concessions to Muslim Lebanese, who now constitute two-thirds of the Lebanese population. By early 1983, both the Israeli army and the U.S. Marines had become militias allied with the Phalangist forces against the majority Muslim, and especially Shiite, community.

Antipathy to Israel, and disillusionment with the United States, increased with the signing of the Lebanese-Israeli Agreement of May 17, 1983. Brokered by the United States, this agreement provided Israel with important political and military privileges in Lebanon, and fell just short of a formal peace treaty. Predictably, the agreement was unacceptable to most Lebanese, and stimulated growth of the Islamic Amal and Hizbullah fundamentalist movements.

Meanwhile, attacks on American Marines in Beirut, and on the IDF in South Lebanon, increased. Destruction of the U.S. Embassy and Marine barracks by Shiite "martyrs" during 1983 paralleled a developing war of attrition waged by Shiites against Israeli troops in South Lebanon. American naval bombardment of Shiite areas, in and around Beirut, and Israeli military repression in South Lebanon delighted the Ayatollahs in Tehran, and must have brought smiles to faces in the Kremlin.

On October 16, 1983, Israeli troops in the Lebanese town of Nabatiyyeh forced their way through a crowd of 50,000 Shiite worshipers who were celebrating Ashuura, the most sacred day in the Shiite religious calendar. In the ensuing confrontation, two Shiites were killed. These deaths inflamed Lebanese resistance throughout the South. Israel responded with an "Iron Fist" policy.

On March 8 of this year, a Lebanese "counter-terrorist" unit planted a bomb in Beirut intended for the Shiite cleric Mohammed Hussein Fadlallah. The bomb missed its target, but killed 92, mainly Shiite civilians. As a result, fundamentalist extremism in Lebanon metastasized. Tragically, Lebanese fundamentalism now marches in step with Soviet policy.

Israel's recent transfer of 1,200 Lebanese Shiites from Lebanon to Israel violated Article 49 of the Fourth Geneva Convention of 1949, and led directly to the TWA hijacking. Muslims see this Israeli action as kidnapping, and ask why the United States refuses to "give in to (Arab) terrorism" while ignoring or condoning the Israeli variety.

Protection of American national interests in the Middle East requires a separation of U.S. from Israeli policy. Greater

American understanding of Islamic culture and values might reclaim some of America's lost respect. Certainly, a balanced U.S. policy would strengthen moderate Arab regimes. Above all, it would help diminish terrorism, undermine fundamentalism, and contain the Soviet Union, which is the primary beneficiary of the present U.S. policy.

—**Dr. Antony T. Sullivan**  
Director,  
Near East Support Services

### OCTOBER- NOVEMBER

The center hosted two public policy seminars during October-November. These seminars featured Dr. Antony Sullivan, director of Near East Support Services, and Lt. Gen. Daniel Graham, a founding father of "star wars."

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Dr. Allan Meltzer, internationally known economist, gave a lecture on campus. During his stopover in Dallas, he attended a dinner given in his honor by Rawles Fulgham, a member of the center's national advisory board.

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Dr. Winston Power, superintendent of Highland Park Independent School District, and his three top associates visited the center and the College of Education for a discussion of cooperative education projects concerning free enterprise.

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Dr. Steve Pejovich attended the Heritage Foundation reception in Washington, D.C., honoring Sen. Barry Goldwater. Sen. Gramm, James Miller and other friends of the center were on hand to honor Sen. Goldwater.

## NEW PROTECTIONISM— OLD SOPHISTRY



Sen. Phil Gramm

Following World War II, economic enlightenment induced both Democrats and Republicans to support sweeping reductions in traditional U.S. trade barriers, producing an explosion in world trade that fueled Western economic development. This 40-year movement toward freer trade, however, is now threatened by a wave of protectionist sentiment sweeping the country and Congress.

Unlike the traditional special-interest appeal of protectionism, the fundamental thesis of the New Protectionists is that the U.S. trade deficit causes the loss of millions of jobs to Japan and the European Community. The most remarkable aspect of this thesis is that it has gone virtually unchallenged.

The facts are these:

- The U.S. has created eight million new jobs in the past three years, more than Europe and Japan combined in the past decade.
- Unemployment in the U.S. has declined for three years, while the unemployment rate in Japan has risen 13 percent and the unemployment rate in the European Community has risen 17 percent.

In short, while the trade deficit has tripled, the U.S. has created jobs at a rate unprecedented in the postwar period. At the same time, Europe has stagnated and Japan has slowed.

The protectionists are looking at only the balance-of-trade account instead of the entire balance of payments, which includes investment and debt service.

The exchange rate between the U.S. dollar and each foreign currency is determined by the supply and demand for dollars in each foreign currency. If Americans decide to buy from or to invest in Japan, they must buy yen with dollars. Thus, the value of the yen rises and the value of the dollar, relative to the yen, falls. The reverse happens when Japanese decide to buy more goods and services from the U.S. or to make investments in the American economy. The exchange rate between the dollar and the yen is determined at that point where the number of dollars that Americans want to convert into yen equals the number of yen that Japanese citizens want to convert into dollars.

Thus, at any given moment, the overall exchange rate is determined by the decision of Americans to buy Japanese cars, Korean shirts, Mexican trousers, and the millions of other spending and investment decisions about the world market made by Americans relative to the decision of foreigners to buy American goods, to invest in America or to pay off debts to the U.S.

In this context, the current deficit in our balance of trade simply means that the U.S. is buying more goods and services than it is selling. But the supply and demand for dollars in each foreign currency, by the definition of double-entry bookkeeping, must be in balance. Thus, while the dollar, in terms of purchasing power for goods and services, is overvalued relative to most foreign currencies, this premium simply reflects the massive demand for dollars by foreigners to invest or pay off debts in the U.S.

The attractiveness of the U.S. economy for foreign investment is explained by the fact that we have the highest real interest rates and the most rapid economic expansion in the world. The deficit in our trade account is simply a reflection of the massive net capital flow into the U.S., capital inflow that has funded the federal budget deficit, and the economic recovery.

Contrary to New Protectionist arguments, tariffs will not reduce the trade deficit. When tariffs are imposed, goods that the U.S. imports become more expensive and Americans therefore buy domestic goods in areas where the U.S. is not competitive in the world market. While jobs are created or preserved in those areas, estimates by the Federal Trade Commission suggest that the cost to the consumer greatly exceeds the wages paid. For example, the FTC has found that even under very conservative assumptions, including the assumption that no retaliation occurs, the loss to consumers from "voluntary restraints" on Japanese cars was about \$241,000 per U.S. job saved. Tuna tariffs cost the U.S. consumer roughly \$240,000 per job saved. The cost per job for textile quotas was \$43,000; for steel, \$114,000.

But the problem goes beyond simple inefficiency. Tariffs and quotas, by lowering the demand for foreign goods, lower the supply of U.S. dollars on the world currency market, raise the value of the dollar, and make American exports less attractive, thus lowering employment in industries where the U.S. is most efficient and most competitive.

The net result is that protectionism does not create jobs, the nation is made poorer as prices rise, and the American economy becomes less competitive as jobs are transferred from our most efficient, most competitive sectors to our least efficient, least competitive sectors.

The most important points to be made about the trade crisis is that there really is none. The U.S. is not, on net, losing jobs, but is instead creating jobs faster than any of its trading partners. Protectionism would not only be ineffective in increasing national employment, but also would, in fact, increase inflation, lower national income and make the American economy less competitive. So far as the horrors of being a net debtor nation are concerned, we must remember that as a net debtor nation between 1867 and 1914, the U.S. experienced the most rapid, sustained economic growth in the history of mankind.

Our primary cause for alarm should be our own federal budget deficit. A reduction of the deficit would cut federal borrowing, lower interest rates, reduce the value of the dollar, and free capital to generate economic growth and jobs in the U.S. and around the world.

Because Congress is unwilling to deal with the federal budget deficit, it has attempted to shift public attention to the trade deficit and divert the blame for the U.S.'s problems to "foreigners" who can't vote in the U.S. elections. The public would be well served if Congress got on with the real job of lowering the federal budget deficit before politics and ignorance reduce world trade, lower world income, create a world financial crisis, and imperil the well-being and defense of the West, all in the name of buying a few votes on the protectionist issue and running away from the real cause of our problems—the federal deficit.

—Phil Gramm  
U.S. Senator, Texas

*Sen. Gramm is a former professor of economics at Texas A&M University. He is a member of the center's advisory board.*



## THIRD ANNUAL EDITOR'S CONFERENCE HUGE SUCCESS



The center's Third Annual Conference for Editors of Texas Newspapers took place October 11-12 in San Antonio. This year's conference was enlarged to include out-of-state newspapers and selected businessmen. Forty-three newspapers, including papers from Oklahoma, Louisiana and Arkansas, were represented. More than 120 people attended the two-day conference.

The Conference for Editors was the brainchild of the late H. B. Zachry of San Antonio, a long-time supporter of the center. Mrs. Zachry was a prominent participant in this year's conference, as she had been in the previous two.

The conference began with a dynamic luncheon address by Peter Grace, formerly chairman of the widely-acclaimed Grace Commission on waste in government. Grace's remarks on government spending (such as "It's Congress that controls spending and that's made up of 535 clowns, minus Phil Gramm") were carried in newspapers and on television throughout the state. Gov. Mark White; Dr. Isabel Muhlfenzl, a prominent television editor from Munich, West Germany; and Robert Reilly, special assistant to the President; addressed

the afternoon session. Gov. White's remarks concerned the economic picture in Texas and how the future of Texas is linked to the federal deficit. Dr. Muhlfenzl discussed the way the United States is perceived by the European media. Bob Reilly gave an effective and powerful message on the Marxist threat in Central America.

Carl Anderson, special assistant to the President for domestic issues, and Manuel Johnson, assistant secretary of the treasury for economic policy, addressed the dinner audience. Anderson gave the conference an informative briefing on the White House's domestic policy, with particular emphasis on spending. Johnson gave an extensive analysis of the President's program on tax reform. With remarkable timing, the White House

*Continued on next page*

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From page five

announced Dr. Johnson's appointment to the Board of Governors of the Federal Reserve during the afternoon, so this was Johnson's first talk since the appointment.

Billy Hamilton, director of the fiscal management division, Texas Comptroller's Office, opened the Saturday morning session with what he called his "gloom and doom speech" on the state budget situation. The session ended with a talk by Allen Meltzer, professor of economics, Carnegie-Mellon University. Dr. Meltzer, who is cochairman of the frequently quoted "Shadow Open Market Committee," spoke on government spending and taxation.

The conference did not consist solely of formal addresses. As one would expect, there was widespread participation by the editors and others in the audience during the question-and-answer sessions that followed each talk. The

conference ended at 10:30 Saturday morning so that participants could attend the Texas A&M vs. Houston football game that afternoon, although some were rumored to be heading for Dallas to see the Oklahoma vs. Texas game. Steve Pejovich and some members of his board began to plan next year's conference as soon as this one ended.

Those who couldn't come wrote to us:

"Please keep us on your list for the Fourth Annual Conference..."

"Please ask me again..."

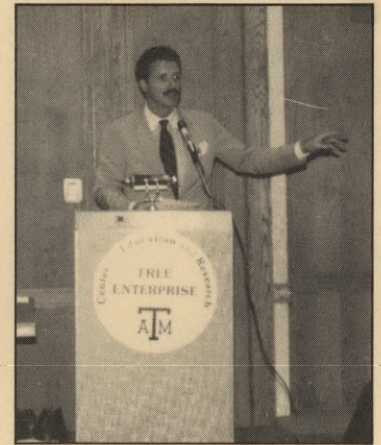
"Please invite us again next year..."

"Put us down for next year..."

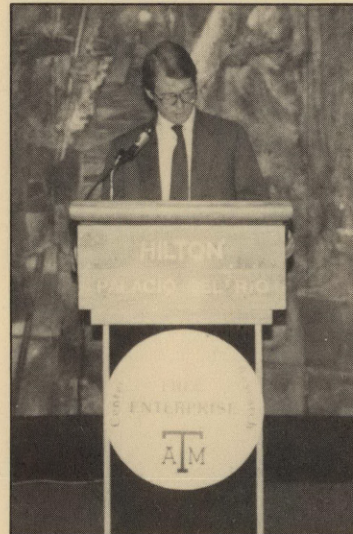
"I want you to know that I personally appreciate your effort, and the effort of Texas A&M in hosting such programs for newspaper editors, and wish you the best in this year's program. Please leave me on the mailing list..."



J. Peter Grace, chairman of W.R. Grace and Company, with Dr. Steve Pejovich, director of the Center for Education and Research in Free Enterprise.



Bob Reilly, special assistant to the President, spoke on the Soviet threat in Central America.



Billy Hamilton giving his powerful message on the future fiscal health of the State of Texas.



Dr. Manuel Johnson, the latest appointee to the board of governors for the Federal Reserve System, in conversation with Lawrence White, former chairman of the board of directors for the Center for Education and Research in Free Enterprise.

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The "powerful foursome"—David Eller, chairman of the Board of Regents for The Texas A&M University System; Dr. Carl Raba, chairman of the Board of Directors for the Center for Education and Research in Free Enterprise; Hon. Mark White, governor of Texas; and Lowry Mays, member of the Board of Regents for The Texas A&M University System.

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