Pegasus

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A newsletter for the Caux Round Table Network
looking at business above the clutter and confetti

Moral Capitalism At Work

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Pegasus

INTRODUCTION

This Issue of Pegasus brings you several items of interest on the role of government with respect to a moral capitalism. It is an often-overlooked truism that markets cannot thrive under conditions of lawlessness. Ethical government is a foundational requirement for any successful capitalism.

In a widely unknown argument, Adam Smith once set forth this connection between government and free markets. In his unpublished lectures on jurisprudence, according to two sets of student notes, Smith argued that a major function of government was to provide society with "bon marché," or reasonably priced goods. This government function was one of stewardship to help those with less wealth lead better lives by having access to cheaper goods and services. The mechanism to be favored by government to help the less fortunate was a free market. Smith argued that competition and division of labor would lower costs and promote the welfare of those who had less money. Thus, for Smith, free markets had a moral role to play in achieving more social justice. Free markets had a social office to perform in parallel with government's responsibilities to protect them from abuse.

The second item presents an instance of Smith's recommendations being used in practice. Last summer, the U.K. Parliamentary Commission on Banking Standards made its recommendations in response to the collapse of financial markets in 2008. A summary of the Commission's conclusions is presented here. The Commission's position is that markets in banking need structure if banking is to serve society by contributing to the advantageous quality of its "bon marché." In particular, bankers need to have their self-interest guided by enlightened methods of compensation. To better align self-interest with the public good, compensation should encourage those active in financial intermediation to take only appropriate risks and conduct themselves with more fiduciary dedication.

In general, the Commission's recommendations validated the proposals the Caux Round Table Global Governing Board made in October, 2008 as the crisis broke across the world.

Third, 50 years ago this month, American President Lyndon Johnson proposed government programs to promote more robust access to free market benefits on the part of those who lived in poverty. President Johnson's vision, as you will see from his remarks below, was not a form of regulatory socialism with state ownership of the means of production. His instinct was to build larger stocks of human capital and social capital, which, in turn, would contribute to more successful enterprise, enhanced specialization and division of labor. This, he believed, would result in lower costs and raised living standards. His War on Poverty proposal was very much in line with Adam Smith's recommendations on the patronage by government of the social forces that produced "bon marché."

Finally, in a retrospective comment on how President Johnson's War on Poverty turned out, the thoughtful economic commentator Robert Samuelson noted that though much money was spent, after 50 years of effort, many

Americans still have not acquired adequate stocks of personal, human and social capital with which to successfully

participate in the market economy. Samuelson's conclusion is important. He reminds us that some improvements to the human condition are beyond the power of government to achieve. They must be incubated in and nourished by civil society itself - in families, in schools, in institutions of faith and religion and in the culture itself. The effort to promote ethics and responsibility and education and insight is part of the unfolding evolution of social justice towards greater equality of both opportunity provided and results earned.

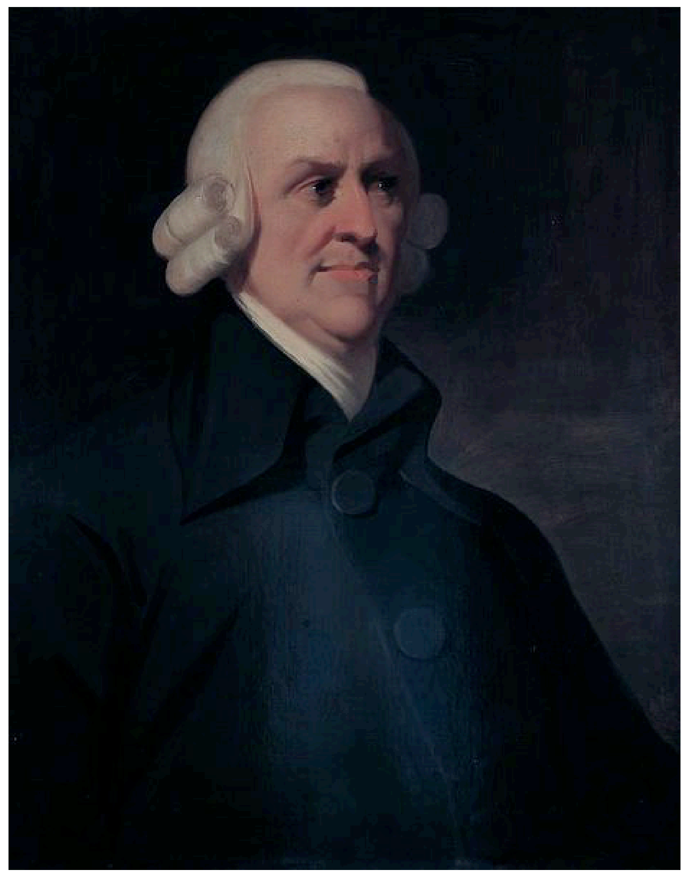
Stephen B. Young
Global Executive Director
Caux Round Table

ADAM SMITH ON THE **MORALITY OF FREE MARKETS**

BY **STEPHEN B. YOUNG**
GLOBAL EXECUTIVE DIRECTOR
THE CAUX ROUND TABLE

As professor of moral philosophy at the University of Glasgow, Adam Smith divided his subject into four parts: 1) natural theology; 2) ethics (his thoughts on which he published as Theory of Moral Sentiments); 3) justice; and 4) political regulation founded upon expediency (his thoughts on which he published as An Inquiry into the Nature and Causes of the Wealth of Nations). He intended to, but never did, publish his thinking on justice. However, in 1895, a manuscript of student notes on Smith's lectures on justice during the 1766 term was discovered and then, in 1958, another set of notes from his lectures on the same topic during the 1762-63 term was found. These student notes provide us with an important insight into Smith's formulation of the moral grounds for free market capitalism and how he subordinated capitalism to arguments about justice.

Smith denominated his approach to the provision of justice as jurisprudence, or the rules by which civil governments ought to be directed. Smith subordinated the power of the state to moral considerations. Implicitly, he considered the state to be a servant, not a master, of society in line with the Whig tradition of responsible constitutional government as previously set forth by John Locke.



Adam Smith

The first goal of civil government, Smith argued, was to provide security of property, maintaining individuals in their rights. The second service to be provided is what Smith called "the opulence of the state." This public service he called by the French term, "Police," telling his students that "Whatever regulations are made with respect to the trade, commerce, agriculture, manufactures of the country are considered as belonging to the police."

As to the public good to be secured by good "Police," Smith used an anecdote from French administration. He recalled that in 1677 upon being appointed Intendent of Paris, M. D'Argenson was told that the King required three things of him: 1) that the city be kept clean; 2) that ease and security be provided; and 3) that bon marché, or cheapness of provisions, be facilitated. Since price varies with supply, Smith noted, achieving bon marché required keeping the market supplied with all sorts of commodities – the more the supply, the lower the price.

Such a policy of good "Police" to lower the cost of goods required promoting free communication between town and country, but also increasing the productive capacity of the country. Smith, thereupon, entered into consideration of "the proper means of introducing plenty and abundance into the country, that is, the cheapness of goods of all sorts." The moral end of government was to improve the lives of citizens through their access to goods and services.

Seeking to understand how to enhance plenty and abundance, Smith offered reflections on how economic activity works in practice. He rested the drive to produce on psychology – people value convenience, rarity, improvements to their lives and satisfactions of their fancies. Demand calls forth production. Smith noted the "thousand arts," which have been invented to supply the wants of others. Demand for Smith was integral with individual rights and autonomy. The needs of individuals taken as worthy ends jointly throw out a blanket of justification over economic activity. The market becomes of value because it responds to the value propositions of consumers. The greater the number of consumers, the more value can be generated by markets through bon marché.

The morality of the system of production rested on the moral visions of its participants. "All the several arts and businesses in life end to render the conveniences and necessities of life more attainable." "The end of law and government," said Smith, "was to give the inhabitants of the country opportunity for the improvement of all the various arts and sciences."

Smith noted the capacity of the division of labor to increase the scale of production and to lower costs. Rational enterprise – the use of capital to expand production with machines – was justified as the means to provide bon marché – lower prices for the people.

Accepting that some will be rich and others poor, Smith affirmed that economic growth would help both. Those who brought enterprises into being would gain wealth, but as they lowered costs through expanded output, the public would be far better supplied and the workers far better rewarded. He asserted that with this system of production, wages for workers could rise significantly, but the cost of goods would remain low to facilitate mass consumption by all.

Smith noted that as a result of economic development, an ordinary day-laborer in England and Scotland enjoyed more conveniences and luxuries of life than a prince in India at the head of 1,000 minions. The blue woolen coat of the English laborer, argued Smith, was the product of the labor of perhaps 100 artificers – all made subordinate to his pleasure by the workings of a free market and production to scale.

When goods are scarce, only the rich will have them: “Whatever raises or keeps up the price of [goods] diminishes the opulence and happiness and ease of the country.” He affirmed that whatever acts of “Police” raise the market price above the natural one set by free competition also diminish public opulence and the wealth of the state since “every discouragement to industry therefore hurts opulence in the nation.” Therefore, he concluded that monopolies diminish opulence, as do taxes on industry.

For Smith, the end of capitalism was the public good provided by the “wealth of nations” – not for the capitalists alone, but most especially, to lift up the common citizen, including the poor.

CHANGING BANKING **FOR GOOD**

(AN EXCERPT FROM THE U.K. PARLIAMENTARY COMMISSION ON BANKING STANDARD'S REPORT)

Summary

Our approach

The U.K. banking sector's ability both to perform its crucial role in support of the real economy and to maintain international pre-eminence has been eroded by a profound loss of trust, born of profound lapses in banking standards. The Commission makes proposals to enable trust to be restored in banking. These proposals have five themes:

- making individual responsibility in banking a reality, especially at the most senior levels;
- reforming governance within banks to reinforce each bank's responsibility for its own safety and soundness and for the maintenance of standards;
- creating better functioning and more diverse banking markets in order to empower consumers and provide greater discipline on banks to raise standards;
- reinforcing the responsibilities of regulators in the exercise of judgment in deploying their current and proposed new powers; and
- specifying the responsibilities of the Government and of future governments and parliaments.

No single change, however dramatic, will address the problems of banking standards. Reform across several fronts is badly needed and in ways that will endure when memories of recent crises and scandals fade.

Making individual responsibility a reality

The problem

Too many bankers, especially at the most senior levels, have operated in an environment with insufficient personal responsibility. Top bankers dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making. They then faced little realistic prospects of financial penalties or more serious sanctions commensurate with the severity of the failures with which they were associated. Individual incentives have not been consistent with high collective standards, often the opposite.

…

Incentives for better behavior

Remuneration has incentivized misconduct and excessive risk-taking, reinforcing a culture where poor standards were often considered normal. Many bank staff have been paid too much for doing the wrong things, with bonuses awarded and paid before the long-term consequences became apparent. The potential rewards for fleeting short-term success have sometimes been huge, but the penalties for failure, often manifest later, have been much smaller or negligible. Despite recent reforms, many of these problems persist.

The Commission proposes a radical re-shaping of remuneration for senior persons and licensed bank staff, driven by a new remuneration code so that incentives and disincentives more closely reflect the longer run balance between business risks and rewards. The main features of the redesign are as follows:

- much more remuneration to be deferred and, in many cases, for much longer periods of up to 10 years;
- more of that deferred remuneration to be in forms which favor the long-term performance and soundness of the firm, such as bail-in bonds;
- the avoidance of reliance on narrow measures of bank profitability in calculating remuneration, with particular skepticism reserved for return on equity;
- individual claims on outstanding deferred remuneration to be subject to cancellation in the light of individual or wider misconduct or a downturn in the performance of the bank or a business area; and
- powers to enable deferred remuneration to senior persons and licensed individuals, as well as any unvested pension rights and entitlements associated with loss of office, to be cancelled in any case in which a bank requires direct taxpayer support.

A new approach to enforcement against individuals

A more effective sanctions regime against individuals is essential for the restoration of trust in banking. The current system is failing: enforcement action against approved persons at senior levels has been unusual, despite multiple banking failures. Regulators have rarely been able to penetrate an accountability firewall of collective responsibility in firms that prevents actions against individuals. The patchy scope of the approved persons regime, which has left people, including many involved in the Libor scandal, beyond effective enforcement.

The Commission envisages a new approach to sanctions and enforcement against individuals:

- all key responsibilities within a bank must be assigned to a specific, senior individual. Even when responsibilities are delegated or subject to collective decision-making, that responsibility will remain with the designated individual;
- the attribution of individual responsibility will, for the first time, provide for the full use of the range of civil powers that regulators already have to sanction individuals. These include fines, restrictions on responsibilities and a ban from the industry;
- the scope of the new licensing regime will ensure that all those who can do serious harm are subject to the full range of civil enforcement powers. This is a broader

> Without contraries is no progression. Attraction and repulsion, reason and energy, love and hate, are necessary to human existence.
>
> *- William Blake*

"The Gherkin" skyscraper in London's financial district

group than those to whom those powers currently extend;

- in a case of failure leading to successful enforcement action against a firm, there will be a requirement on relevant senior persons to demonstrate that they took all reasonable steps to prevent or mitigate the effects of a specified failing. Those unable to do so would face possible individual enforcement action, switching the burden of proof away from the regulators; and

- a criminal offence will be established applying to senior persons carrying out their professional responsibilities in a reckless manner, which may carry a prison sentence. Following a conviction, the remuneration received by an individual during the period of reckless behavior should be recoverable through separate civil proceedings.

Reforming governance to reinforce individual responsibility

The financial crisis and multiple conduct failures have exposed serious flaws in governance. Potemkin villages were created in firms giving the appearance of effective control and oversight without the reality. Non-executive directors lacked the capacity or incentives to challenge the executives. Sometimes, those executives with the greatest insight into risks being added to balance sheets were cut off from decision-makers at the board level or lacked the necessary status to speak up. Poor governance and controls are illustrated by the rarity of whistle-blowing, either within or beyond the firm, even where, such as in the case of Libor manipulation, prolonged and blatant misconduct has been evident. The Commission makes the following recommendations for improvement:

- individual and direct lines of access and accountability to the board for the heads of the risk, compliance and internal audit functions and much greater levels of protection for their independence;

- personal responsibility for each individual director for the safety and soundness of the firm and a government consultation on amending the Companies Act to prioritize financial safety over shareholder interests in the case of banks;

- direct personal responsibility on the chairman to ensure the effective operation of the board, including effective challenge by non-executives and on the senior independent director, supported by the regulator, to ensure that the chairman fulfils this role; and

- individual responsibility for a named non-executive director, usually the chairman, to oversee fair and effective whistle-blowing procedures and to be held accountable when an individual suffers detriment in consequence of blowing the whistle.

Better functioning markets

The U.K. banking sector is not as competitive as it should be. Retail and business customers alike are often denied sufficient choice or access to enough information to exercise effective judgment. Greater market discipline can help address the resulting consumer detriment and lapses in standards and buttress regulation. Where such remedies can be found, they should be deployed. The Commission proposes that:

- the Government immediately establish an independent panel of experts to assess the means of enabling much greater personal bank account portability;

- the treasury examine the tax treatment of peer-to-peer lending and crowdfunding firms to ensure a level playing field with established competitors and review the effectiveness of tax incentives intended to encourage investment in community development finance institutions;

- the major banks come to a voluntary agreement on minimum standards for the provision of basic bank accounts, including access to the payments system and money management services and free use of the ATM network within 12 months or be subject to a new statutory duty;

- competition be an objective of the PRA, subject to its overriding responsibility for financial stability;

- the Competition and Markets Authority immediately commence a full market study of competition in the retail and SME banking sectors to be completed on a timetable consistent with a market investigation reference by the end of 2015; and

- the Government should immediately announce a process for considering alternative strategies for the future of RBS, including splitting the bank and putting its bad assets in a separate legal entity (a 'good bank / bad bank' split), to report by September 2013.

Reinforcing the responsibilities of the regulators

Serious regulatory failure has contributed to the failings in banking standards. The misjudgment of the risks in the pre-crisis period was reinforced by a regulatory approach focused on detailed rules and processes that all but guaranteed that the big risks would be missed. Scandals relating to mis-selling by banks were allowed to assume vast proportions, in part because of the slowness and inadequacy of the regulatory response.

Our proposed emphasis on individual responsibility within banks needs to be matched by the replacement of mechanical data collection and box ticking by a much greater emphasis on the exercise of judgment by the regulators, supported by more effective oversight and empowerment tools. In particular:

- supervisors need to be close enough and have a detailed enough understanding of businesses to make swift decisions based on up-to-date information, rather than taking belated actions with the benefit of hindsight;

- the most senior regulatory staff should be expected to use judgment, rather than relying on procedures, and to take direct personal responsibility for ensuring that their engagement with individual banks and the CEO, chairman and the board in particular, is securing the information required best to assess risk. They should expect to be held accountable, ultimately to Parliament, for this crucial role;

- a new tool proposed by the Commission, "special measures," will provide for the deployment of a broader range of regulatory powers when the FCA and PRA are concerned that systemic weaknesses of leadership, risk management and control leave a bank particularly prone to standards failures;

- regulators need to remove obstacles to a more competitive market in banking, including through steps to support the development of a more diverse banking market;

- regulators should identify the risks to a judgment-based approach from overly prescriptive international rule books and ensure that Parliament is kept fully informed of them; and

- there should be mandatory dialogue between supervisors and external auditors and a separate set of accounts for regulatory purposes.

The responsibilities of governments and parliaments

There were many players in the development of the crisis in banking that has unfolded since 2007. The behavior of bankers was appalling, but regulators, credit ratings agencies, auditors, governments, many market observers and many individual bank customers in their approach to borrowing created pressures in the same and wrong direction. Governments have a particular responsibility, many of them having been dazzled by the economic growth and tax revenues promised from the banking sector. Implementing the recommendations of the Commission would signal a fresh approach.

The banking industry can better serve both its customers and the needs of the real economy in a way which will also further strengthen the position of the U.K. as the world's leading financial center. To enable this to happen, the recommendations of this Commission must be fully implemented in a coherent manner. They complement reforms already proposed by Parliament and by the Independent Commission on Banking. If fully implemented, the proposals of this Commission's reports can change banking for good.

Hercules and the Hydra Lernaean, Gustav Moreau, 1876

Conclusions and Recommendations

Chapter 1: Introduction

1. Banks in the U.K. have failed in many respects. They have failed taxpayers, who had to bail out a number of banks, including some major institutions, with a cash outlay peaking at £133 billion, equivalent to more than £2,000 for every person in the U.K. They have failed many retail customers with widespread product mis-selling. They have failed their own shareholders by delivering poor, long-term returns and destroying shareholder value. They have failed in their basic function to finance economic growth with businesses unable to obtain the loans that they need at an acceptable price. (Paragraph 1)

2. Banks have a crucial role in the economy. Banking can make an immense contribution to the economic well-being of the U.K. by serving consumers and businesses and by contributing to the country's position as a leading global financial center. The loss of trust in banking has been enormously damaging; there is now a massive opportunity to reform banking standards to strengthen the value of banking in the future and to reinforce the U.K.'s dominant position within the global financial services industry. A reformed banking industry with higher levels of standards has the potential, once again, to be a great asset to the country. (Paragraph 6)

3. The restoration of trust in banking is essential and not just for banks. It is essential to enable the industry better to serve the needs of the real economy and to contribute effectively to the U.K.'s role as a global financial center. (Paragraph 7)

4. The U.K. is a global financial center, but a medium-sized economy. The benefits of being a global financial center are very important in terms of jobs, investment, tax revenue and exports. In finance, the U.K. is a world leader. But being a global financial center with a medium-sized, wider economy also poses risks, as was seen in the bail-outs and huge injections of taxpayers' money, which took place during the financial crisis. It is essential that the risks posed by having a large financial center do not mean that taxpayers or the wider economy are held to ransom. That is why it is right for the U.K. to take measures which not only protect the U.K.'s position as a global financial sector, but also protect the U.K.'s public and economy from the associated risks. Much of this report is about how that should be done. (Paragraph 8)

5. Unless the implicit taxpayer guarantee is explicitly removed, the task of improving banking standards and culture will be immeasurably harder. The principal purpose and effect of the post-banking crisis measures now being implemented, both the requirements of Basel III and through the Banking Reform Bill, is to make it less likely that banks will fail. That is all to the good. But it cannot guarantee that there will never be a major bank failure. It is important to make it clear that should such a failure occur, the bank should be allowed to fail. That is to say that while both the payments system and insured depositors will be protected, there should be no bailout of a bank. (Paragraph 9)

13. Excessive complexity in the major banks is not restricted to organizational structure. The fuelling of the financial crisis by misguided risk models was not simply the consequence of some mathematicians getting their equations wrong. It was the result of ignorance, coupled with excessive faith in the application of mathematical precision by senior management

and by regulators. Many of the elements of this problem remain. (Paragraph 93)

14. One of the most dismal features of the banking industry to emerge from our evidence was the striking limitation on the sense of personal responsibility and accountability of the leaders within the industry for the widespread failings and abuses over which they presided. Ignorance was offered as the main excuse. It was not always accidental. Those who should have been exercising supervisory or leadership roles benefited from an accountability firewall between themselves and individual misconduct and demonstrated a poor, perhaps deliberately poor, understanding of the front line. Senior executives were aware that they would not be punished for what they could not see and promptly donned the blindfolds. Where they could not claim ignorance, they fell back on the claim that everyone was party to a decision so that no individual could be held squarely to blame — the Murder on the Orient Express defense. It is imperative that in the future, senior executives in banks have an incentive to know what is happening on their watch — not an incentive to remain ignorant in case the regulator comes calling. (Paragraph 105)

Paid too much for doing the wrong things

15. Public anger about high pay in banking should not be dismissed as petty jealousy or ignorance of the operation of the free market. Rewards have been paid for failure. They are unjustified. The banks and those who speak for them are keen to present evidence that bonuses have fallen, but fixed pay has risen, offsetting some of the effect of this fall. The result is that overall levels of remuneration in banking have

Stripped of his numbers an economist would have to resort to the old home truths about how the world works: If you tax something, you get less of it; as a general rule an individual manages his affairs better than his neighbor can; it's rude to be bossy; the number of problems that resolve themselves if only you wait long enough is far larger than the number of problems solved by mucking around in them. And the cure is often worse than the disease.

- Andrew Ferguson WSJ, Jan 22, 2014

largely been maintained. Aggregate pay levels of senior bankers have also been unjustified. Given the performance of the banks, these levels of pay have produced excessive costs. Indeed, at a time of pay restraint in the public and private sectors, they will raise significant anger amongst taxpayers who have been required to subsidize these banks. These elevated levels of remuneration are particularly unacceptable when banks are complaining of an inability to lend owing to the need to preserve capital and are also attempting to justify rises in charges for consumers. (Paragraph 111)

16. The calculation of remuneration in investment banking and at the top of banks remains thoroughly dysfunctional. In many cases it is still linked to inappropriate financial measures, often short-term, while long-term risk is not adequately considered. Individuals have incentives to be preoccupied with short-term, leveraged growth, rather than sustainability and good conduct. (Paragraph 116)

17. Though they have been much less generous than in investment banking, poorly constructed incentive schemes in retail banking have also hugely distorted behavior. They are likely to have encouraged mis-selling and misconduct. Senior management set incentive schemes for front-line staff, which provided high rewards for selling products and left staff who did not sell facing pressure, performance management and the risk of dismissal. It shows a disregard for their customers and front-line staff that some senior executives were not even aware of the strong incentives for mis-selling caused by their own bank's schemes. These remuneration practices are ultimately not in the interests of banks themselves, still less of the customers they serve. (Paragraph 119)

19. The professions may not be paragons, but they do at least espouse a strong duty of trust, both towards clients and towards upholding the reputation of the profession as a whole. In contrast, bankers appear to have felt few such constraints on their own behavior. Few bankers felt a duty to monitor or police the actions of their colleagues or to report their misdeeds. Banking culture has all too often been characterized by an absence of any sense of duty to the customer and a similar absence of any sense of collective responsibility to uphold the reputation of the industry. (Paragraph 135)

20. The "three lines of defense" system for controlling risk has been adopted by many banks with the active encouragement of the regulators. It appears to have promoted a wholly misplaced sense of security. Fashionable management school theory appears to have lent undeserved credibility to some chaotic systems. Responsibilities have been blurred, accountability diluted and officers in risk, compliance and internal audit have lacked the status to challenge front-line staff effectively. Much of the system became a box-ticking exercise, whereby processes were followed, but judgment was absent. In the end, everyone loses, particularly customers. (Paragraph 143)

Regulation: barking up the wrong tree

21. That regulation is well-intentioned is no guarantee that it is a force for good. Misconceived and poorly-targeted regulation has been a major contributory factor across the full range of banking standards failings. Regulators cannot always be expected to behave as disinterested guardians who will pursue the "right" approach. They are faced with complex challenges to which the appropriate solutions are ambiguous and contested. They have not in the past always risen

to those challenges satisfactorily. They need to resist the temptation to retreat into a comfort zone of setting complex rules and measuring compliance. They also need to avoid placing too much reliance on complex models, rather than examining actual risk exposures. Regulators were complicit in banks outsourcing responsibility for compliance to them by accepting narrow conformity to rules as evidence of prudent conduct. Such an approach is easily gamed by banks and is no substitute for judgment by regulators. (Paragraph 158)

Insufficient downsides

29. The distorted incentives in banking are nowhere more apparent than in the asymmetry between the rewards for short-term success and costs of long-term failure for individuals. Many bankers were taking part in a one-way bet, where they either won a huge amount or they won slightly less and taxpayers and others picked up the tab, even if some individuals paid a large, reputational price. Many have continued to prosper, while others, including the taxpayer, continue to foot the bill for their mistakes. There have been a few isolated instances of individual sanction, but these have rarely reached to the very top of banks. This sanctioning of only a few individuals contributes to the myth that recent scandals can be seen as the result of the actions of a few 'rotten apples,' rather than much deeper failings in banks by regulators and other parts of the financial services industry. (Paragraph 203)

30. Many of the rewards have been for activities previously undertaken within a partnership model, a model under which a more appropriate balance between risk and reward exists. The return of these activities to partnership-based vehicles, such as hedge funds, could help redress the balance and is to be encouraged. (Paragraph 204)

(The full report can be found at the U.K. Parliamentary Commission on Banking Standard's website: http://www.parliament.uk/bankingstandards)

AN EXCERPT FROM **PRESIDENT LYNDON B. JOHNSON'S** 1964 STATE OF THE UNION ADDRESS

(As delivered in person before a joint session of Congress)

Mr. Speaker, Mr. President, Members of the House and Senate, my fellow Americans:

This budget, and this year's legislative program, are designed to help each and every American citizen fulfill his basic hopes - his hopes for a fair chance to make good; his hopes for fair play from the law; his hopes for a full-time job on full-time pay; his hopes for a decent home for his family in a decent community; his hopes for a good school for his children with good teachers; and his hopes for security when faced with sickness or unemployment or old age.

Unfortunately, many Americans live on the outskirts of hope - some because of their poverty, and some because of their color, and all too many because of both. Our task is to help replace their despair with opportunity.

This administration today, here and now, declares unconditional war on poverty in America. I urge this Congress and all Americans to join with me in that effort.

It will not be a short or easy struggle, no single weapon or strategy will suffice, but we shall not rest until that war is won. The richest Nation on earth can afford to win it. We cannot afford to lose it. One thousand dollars invested in salvaging an unemployable youth today can return $40,000 or more in his lifetime.

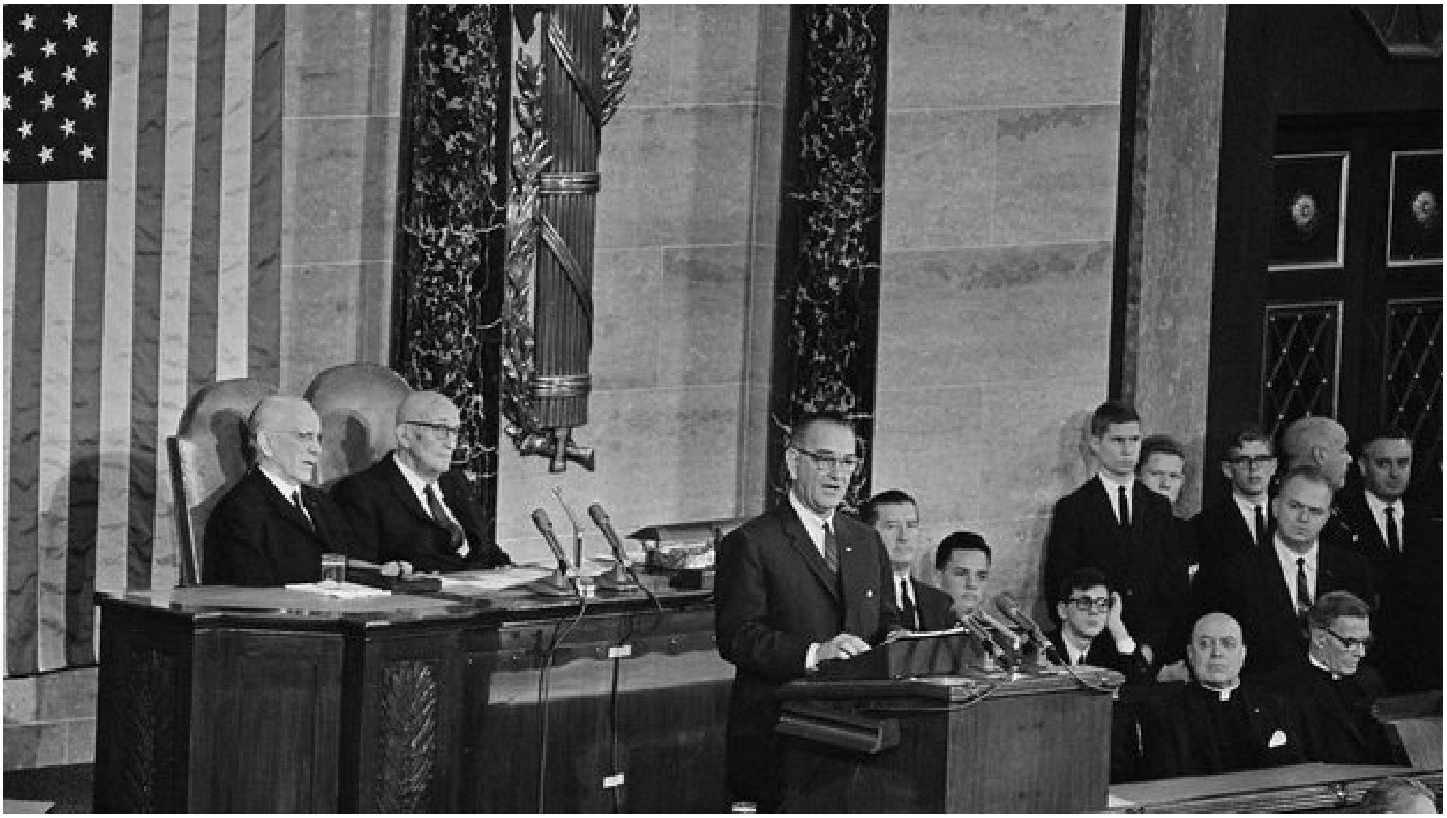
Poverty is a national problem, requiring improved national organization and support. But this attack, to be effective, must also be organized at the State and the local level and must be supported and directed by State and local efforts.

For the war against poverty will not be won here in Washington. It must be won in the field, in every private home, in every public office, from the courthouse to the White House.

The program I shall propose will emphasize this cooperative approach to help that one-fifth of all American families with incomes too small to even meet their basic needs.

Our chief weapons in a more pinpointed attack will be better schools, and better health, and better homes, and better training, and better job opportunities to help more Americans, especially young Americans, escape from squalor and misery and unemployment rolls where other citizens help to carry them.

Very often a lack of jobs and money is not the cause of poverty, but the symptom. The cause may lie deeper in our failure to give our fellow citizens a fair chance to develop their own capacities, in a lack of education and training, in a lack of medical care and housing, in a lack of decent communities in which to live and bring up their children.



President Lyndon B. Johnson, State of the Union Address, January 8, 1964

But whatever the cause, our joint Federal-local effort must pursue poverty, pursue it wherever it exists - in city slums and small towns, in sharecropper shacks or in migrant worker camps, on Indian Reservations, among whites as well as Negroes, among the young as well as the aged, in the boom towns and in the depressed areas.

Our aim is not only to relieve the symptom of poverty, but to cure it and, above all, to prevent it.

My good friends and my fellow Americans: In these last 7 sorrowful weeks, we have learned anew that nothing is so enduring as faith, and nothing is so degrading as hate.

John Kennedy was a victim of hate, but he was also a great builder of faith - faith in our fellow Americans, whatever their creed or their color or their station in life; faith in the future of man, whatever his divisions and differences.

This faith was echoed in all parts of the world. On every continent and in every land to which Mrs. Johnson and I traveled, we found faith and hope and love toward this land of America and toward our people.

So I ask you now in the Congress and in the country to join with me in expressing and fulfilling that faith in working for a nation, a nation that is free from want and a world that is free from hate - a world of peace and justice, and freedom and abundance, for our time and for all time to come.

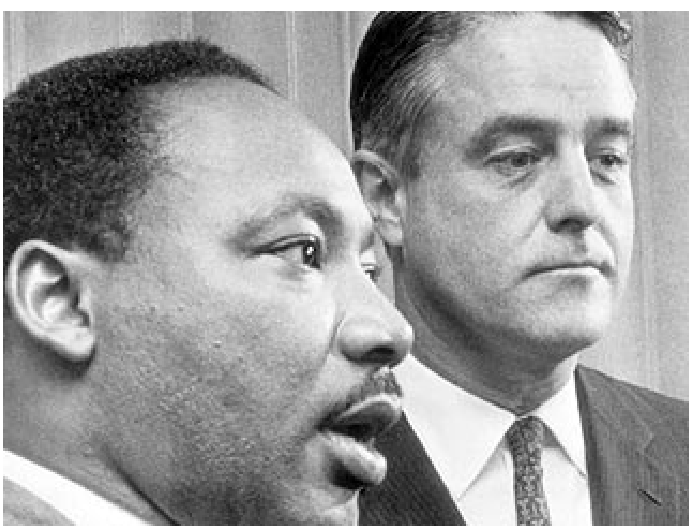
Source: Public Papers of the Presidents of the United States: Lyndon B. Johnson, 1963-64. Volume I, entry 91, pp. 112-118. Washington, D. C.: Government Printing Office, 1965.

A REFLECTION ON THE **WAR ON POVERTY**

BY **BOB SAMUELSON**

The War on Poverty is often branded a failure because the share of Americans below the official poverty line has barely budged. In 1982, at the end of a harsh recession, it was 15 percent. In 2010, after the Great Recession, it was 15 percent.

The trouble is that the official poverty rate is a lousy indicator of people's material well-being. It misses all that the poor get -- their total consumption. It counts cash transfers from government, but not non-cash transfers (food stamps, school lunches) and tax refunds under the Earned Income Tax Credit. Some income is under-reported. Also, the official poverty line overstates price increases and, therefore, understates purchasing power.



Dr. Martin Luther King, Jr. and Sargent Shriver, first Director of the War on Poverty

Eliminating these defects, economists Bruce Meyer of the University of Chicago and James Sullivan of the University of Notre Dame built a consumption-based index that estimates the 2010 poverty rate at about 5 percent.

People at the bottom aren't well-off, but they're better off than they once were. Among the official poor, half have computers, 43 percent have central air conditioning and 36 percent have dishwashers, report Meyer and Sullivan. These advances are especially impressive because the massive immigration of unskilled Hispanic workers inflated the ranks of the poor. From 1990 to 2007, all the increase in official poverty was among Hispanics.

But this wasn't the war LBJ envisioned -- and we lost that war, which aimed to catapult the poor into the economic mainstream. The root problem, Johnson said, was that many poor didn't have "a fair chance to develop their own capacities." Government would remove the obstacles holding them back through "better schools ... health ... training." Thus liberated, most poor people would become more productive, independent and middle class. A phrase at the time was "a hand up, not a handout."

This failed dismally. America remains a tiered society with millions at the bottom still living more chaotic and vulnerable lives. Government's capacity to boost them into the mainstream was oversold. Although Head Start produces some gains for 3 and 4 year-olds, improvements dissipate quickly. One study found most disappeared by third grade. Schools are continually "reformed" because they don't produce better results.

The War on Poverty Became the Welfare State

Worse, the breakdown of marriage and spread of single-parent households suggest that poverty may grow.

From 1963 to 2012, the share of families with children under 18 headed by a single parent tripled to 32 percent. It's 26 percent among whites, 34 percent among Hispanics and 59 percent among African Americans. Just why is murky. Low-income men may flunk as attractive marriage mates. Or, "women can live independently more easily rather than put up with less satisfactory marriages," as Brookings' Isabel Sawhill says. Regardless of the causes and despite many exceptions, children in single-parent households face a harder future. They're more likely to drop out of school, get pregnant before age 20 or be unemployed.

Sargent Shriver, first Director of the Office of Economic Opportunity, in the 1960s

Poverty Becomes Self-Perpetuating

The War on Poverty's success at strengthening the social safety net -- a boon in the Great Recession -- should not obscure its failure as an engine of self-improvement. Government is fairly good at handing out money; it's less good at changing behavior. The two roles intersect. If the safety net is too generous, it will weaken work incentives. If it's too stingy, it will condone suffering. This tale of two wars has left the fight against poverty in a costly and unsatisfying stalemate.

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