

THE S PPLY- SIDE SOLUTION

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The Supply-Side Solution

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CHATHAM HOUSE PUBLISHERS, INC.
Chatham, New Jersey

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CHATHAM HOUSE PUBLISHERS, INC.
Post Office Box One
Chatham, New Jersey 07928

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PUBLISHER: Edward Artinian
PRODUCTION SUPERVISOR: Linda Sabol
COVER DESIGN: Lawrence Ratzkin
COMPOSITION: Chatham Composer
PRINTING AND BINDING: Hamilton Printing Company

LIBRARY OF CONGRESS CATALOGING IN PUBLICATION DATA

Main entry under title:

The supply-side solution

Bibliography: p.

Contents: We are all supply-siders now! / John A.

Tatom — The economic effects of tax changes /

Norman B. Ture — The bankruptcy of keynesian
econometric models / Michael K. Evans — [etc.]

I. Supply-side economics—Addresses, essays,
lectures. I. Bartlett, Bruce R., 1951-

II. Roth, Timothy P.

HB24I.S966 1983 338.9 83-7619

ISBN 0-934540-18-7

Manufactured in the United States of America

10 9 8 7 6 5 4 3 2 1

Acknowledgments

We would like to thank the following authors, periodicals, and publishers for their kind permission to reprint:

John A. Tatom, "We Are All Supply-Siders Now!" *Federal Reserve Bank of St. Louis Review* (May 1981): 18-30.

Norman B. Ture, "The Economic Effects of Tax Changes: A Neoclassical Analysis," in Congress of the United States, Joint Economic Committee, *Special Study on Economic Change*, volume 4, *Stagflation: The Causes, Effects, and Solutions* (Washington, D.C.: Government Printing Office, 1980), pp. 316-47.

Michael K. Evans, "The Bankruptcy of Keynesian Econometric Models," *Challenge* (January/February 1980): 13-19. This article is reprinted with the permission of the publisher, M.E. Sharpe, Inc., Armonk, New York 10504.

Paul Craig Roberts, "The Breakdown of the Keynesian Model." Reprinted with permission of the author from *The Public Interest*, no. 52 (Summer 1978): 20-33. © 1978 by National Affairs, Inc.

Michael J. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, 86, no. 2, pt. 2 (April 1978): S3-S27. © 1978 by The University of Chicago.

Robert E. Keleher, "Supply-Side Tax Policy: Reviewing the Evidence," *Federal Reserve Bank of Atlanta Economic Review* (April 1981): 16-21.

Arthur B. Laffer, "Government Exactions and Revenue Deficiencies," *Cato Journal* 1, no. 1 (Spring 1981): 1-21. Copyright © Cato Institute. All rights reserved.

Don Fullerton, "Can Tax Revenues Go Up When Tax Rates Go Down?" (Washington, D.C.: Department of the Treasury, Office of Tax Analysis, Paper 41, September 1980).

Charles E. Stuart, "Swedish Tax Rates, Labor Supply, and Tax Revenues," *Journal of Political Economy* 89, no. 5 (October 1981): 1020-38. © 1981 by The University of Chicago.

Ronald E. Grieson, "Theoretical Analysis and Empirical Measurements of the Effects of the Philadelphia Income Tax," *Journal of Urban Economics* 8 (July 1980): 123-37. Copyright © 1980 by Academic Press, Inc. All rights of reproduction in any form reserved.

Otto Eckstein, "A Time for Supply Economics," in Congress of the United States, *Forecasting the Supply Side of the Economy: Hearing before the Joint Economic Committee*, 96th Congress, 2nd session (Washington, D.C.: Government Printing Office, 1980), pp. 24-31.

Michael J. Boskin, "Some Issues in 'Supply-Side' Economics," in *Supply Shocks, Incentives and National Wealth*, ed. Karl Brunner and Allan Meltzer (Amsterdam: North-Holland Publishing Co., 1981), pp. 201-20.

Jerry A. Hausman, "Labor Supply," in *How Taxes Affect Economic Behavior*, ed. Henry J. Aaron and Joseph A. Pechman (Washington, D.C.: Brookings Institution, 1981), pp. 27-64. Copyright © 1981 by The Brookings Institution, 1775 Massachusetts Avenue, N.W., Washington, D.C. 20036. Appendices not reprinted.

Craig K. Elwell, "Supply-Side Economics: A General Perspective," (Washington, D.C.: Congressional Research Service, Library of Congress, 12 May 1981).

Peter M. Gutmann, "Taxes and the Supply of National Output," *Financial Analysts Journal* (November/December 1979): 64-66. All rights reserved. Copyright © The Financial Analysts Federation, 1979.

Aris Protopapadakis, "Supply-Side Economics: What Chance for Success?" *Federal Reserve Bank of Philadelphia Business Review* (May/June 1981): 11-23.

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Bruce Bartlett and Timothy P. Roth

INTRODUCTION

“The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is generally understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.”¹ With these words John Maynard Keynes ended his *General Theory of Employment Interest and Money*, the most influential work of the twentieth century. Ironically, Keynes himself ended up as a “defunct economist” when his theories failed to explain both stagflation and hyperinflation in the 1970s. But, as Keynes noted, even defunct economists can have a powerful influence on practical people. Most major economic forecasting models used today are still based on Keynesian assumptions.

Supply-side economics developed as an explicit repudiation of these assumptions, which essentially argue that demand is the lever that controls the economy. In effect, Keynes said that demand creates supply: Give people more money to spend, by running budget deficits and printing money, and goods and services will be produced to supply this demand.

This view contradicted the teachings of classical economics as it had existed since the time of Adam Smith. In the 1830s the great French economist Jean Baptiste Say articulated what has come to be called supply-side economics. Say’s Law declared that goods are ultimately paid for with other goods. Thus, it is aggregate supply that determines national income. Consumption (demand) therefore is an effect, not a cause, of production. If the creation of goods and services (supply) were encouraged, consumption (demand) would follow automatically. As Say put it: “The encouragement of mere consumption is of no benefit to commerce; for the difficulty lies in supplying the means, not in stimulating the desire of consumption; and we have seen that production alone, furnishes those means. Thus, it is the aim of good government to stimulate production, of bad government to encourage consumption.”²

The Great Depression of the 1930s seemed to contradict Say’s Law — there were plenty of goods and idle factories around, but people did not have any money with which to purchase goods. In fact, there was a serious problem with the demand side of the economy; but it was primarily a monetary problem, not a refutation of Say’s Law. In *A Monetary History of the United States, 1867-1960*, Milton Friedman and Anna Schwartz demonstrate that between 1929 and 1932 the Federal Reserve Board caused the U.S. money stock to decline by over a third. When rigidities in the economy prevented prices and wages from

falling by an equivalent amount, consistent with equilibrium, the depression ensued. A similar situation developed in Great Britain when the Bank of England intentionally deflated the economy in order to restore the pre-World War I exchange rate between the dollar and the pound at \$4.87.

Keynes criticized the British government's monetary policy for causing real wage rates and the real burden of debt to rise, thereby creating vast unemployment. Since workers steadfastly refused to lower their nominal (money) wage rates to a level consistent with the decline in the money stock, Keynes advocated inflation, which would cause real wages to decline (in terms of what they would purchase) while nominal wage rates remained unchanged. Or, as Keynes wrote in *The General Theory*: "Whilst workers will usually resist a reduction of money-wages, it is not their practice to withdraw their labor whenever there is a rise in the price of wage-goods. It is sometimes said that it would be illogical for labor to resist a reduction of money-wages but not to resist a reduction of real wages. . . . But, whether logical or illogical, experience shows that this is how labor in fact behaves."³

In short, Keynes' view is perfectly consistent with the classical view given the conditions that existed; that is, a deflationary depression when wage rates are rigid. Keynes did not deny that wage rate reductions were a cure for unemployment. In *The General Theory* he said, "In general, an increase in employment can only occur to the accompaniment of a decline in the rate of real wages. Thus I am not disputing this vital fact which the classical economists have (rightly) asserted as indefeasible."⁴ What Keynes also said is that the inflationary cure for unemployment is far less painful (particularly in the political sense) than the orthodox cure.

"A change in the quantity of money," said Keynes, "is already within the power of most governments by open-market policy or analogous measures. Having regard to human nature and our institutions, it can only be a foolish person who would prefer a flexible wage policy to a flexible money policy, unless he can point to advantages from the former which are not obtainable from the latter. Moreover, other things being equal, a method which is comparatively easy to apply should be deemed preferable to a method which is probably so difficult as to be impracticable."⁵

The effect was a merger of monetary policy and employment policy, such that one could not be considered independent of the other. This relationship was formalized in the "Phillips Curve," which shows an inverse relationship between inflation and unemployment; that is, the higher one is, the lower the other will be, and vice versa. Sir John Hicks, one of Keynes' principal followers, has noted that this situation has had a profound effect on the conduct of monetary policy. Instead of concerning themselves solely with ensuring the value of the currency, monetary authorities have become the main controllers of macroeconomic policy.⁶

This perversion of the historic role of monetary policy came under strong attack from monetary economists. They argued that there was no long-run money illusion, that workers could not be fooled into accepting lower real

wages by inflation for long. Soon they would begin demanding wage increases to compensate for anticipated inflation and getting escalator clauses written into their contracts. Thus the whole basis for the Phillips Curve would be destroyed. Consequently, as Milton Friedman has strongly argued, the only effect of reducing the value of the currency by increasing the quantity of money would be inflation.⁷

More recently, other monetary economists have argued that insofar as monetary authorities adopt inflationary policies in a futile attempt to reduce unemployment, they actually create unemployment, because inflation disrupts capital markets and increases taxes and interest rates.⁸ The result is a “ratcheting” effect in which higher inflation breeds higher unemployment which breeds higher inflation. Thus, if one examines recent business cycles, one finds higher unemployment at each succeeding peak and higher inflation at each trough. Indeed, we are fast approaching the point where a recession has no effect on inflation, and unemployment will not go down even in a cyclical upswing.

Confronted by such an economic situation, often called “stagflation,” in which the traditional Keynesian cure for unemployment—inflation—failed to work, as in 1974-75 when both unemployment and inflation hit postwar highs, politicians and policymakers were highly receptive to new economic ideas. Supply-side economics began to fill that void.

Supply-siders argue, as Say did, that the encouragement of demand is of no value and only creates inflation. Instead, they emphasize the production of goods and services and the incentives necessary to encourage work, investment, and saving. These incentives are fundamentally determined by relative prices or, more particularly, real after-tax rates of return.

Two prices primarily govern production. First is the price of work relative to leisure. Second is the price of saving relative to consumption. Inflation and tax rates can alter these prices.

The price of leisure is foregone income. The price of work is foregone leisure. If the cost of not working is reduced, either because the tax on each additional dollar earned has been increased or because unemployment compensation or welfare has made unemployment less painful, then people are going to work less. In other words, there is a wedge between what one can earn by working and what one can earn by not working. Reduce that wedge and many people will opt for leisure rather than work.

This is not to say that people on welfare or unemployment compensation are fundamentally lazy. It merely says that people respond to incentives. Thus, to someone who unavoidably loses a job, the existence of unemployment compensation allows that person to be somewhat less inclined to take the first job offered; it may in fact reduce the effort he or she puts into a job search. The result has been a significant increase in the duration of unemployment in recent years. People tend to remain unemployed longer than they used to.

A study of this problem by the U.S. General Accounting Office found that high tax rates were a significant disincentive. The GAO discovered that although unemployment benefit levels have been fixed at 50 percent of a worker’s gross

income, up to state-set maximums, the increase in tax rates in recent years has reduced the gap between average net wages and average (tax-free) unemployment compensation. The result is that most workers replace at least 60 percent of their net wages. In a GAO sample, one-quarter of the workers replaced over 75 percent of their previous net wages, and a few (7 percent) replaced over 100 percent.⁹ Under the circumstances, who wouldn't take the opportunity to put off taking another job for a few months—especially when one's spouse may be working, when one may be getting dividends or pension benefits, or when so many opportunities exist to do work around the house that would otherwise have to be paid for or to do a little work for unreported cash.

Similarly, there is a tradeoff between saving and consumption that is also affected by the tax rate. Consider an economy in which there are no taxes. Now, suppose you have \$1,000. You can either save it or spend it. If the rate of interest is 5 percent, then saving the \$1,000 will yield an income of \$50 per year. Thus, the cost of consuming \$1,000 is \$50 per year. Now suppose a flat tax rate of 50 percent is imposed. To get \$1,000 worth of consumption, you must now earn \$2,000 to start with. But \$2,000 before tax will earn only \$25 per year after tax because the interest is taxed as well as the principal. In order to get the same \$50 per year of after-tax return, you must now earn \$4,000 before tax in order to save \$2,000, which earns \$100 before tax and \$50 after tax. Taxes, therefore, make it twice as costly to save as consume. The result, obviously, is more consumption and less saving.

The Economic Recovery Tax Act of 1981¹⁰ was fundamentally designed to alter the price of work relative to leisure and saving relative to consumption. Marginal tax rates on individual incomes were cut across the board, the maximum tax on so-called unearned income (interest, dividends, and the like) was reduced from 70 to 50 percent, and numerous new incentives were enacted to encourage saving and investment by individuals and corporations. There is no question that work, saving, and output will increase as a result of this legislation;¹¹ the only question is when we will begin to see results and what the magnitudes will be.

Nevertheless, critics of the tax cut remain vocal, arguing that large deficits have been the result. These critics were encouraged when David Stockman, director of the Office of Management and Budget, expressed similar concerns in an interview in the *Atlantic Monthly*.¹² The implication was that taxes should not have been cut so much and that taxes ought now to be raised. However, Stockman himself presented the strongest case against such action when he said, "It is my very strongly held belief that if we fail to cut taxes, then we have no hope, over the next 3 or 4 years, of bringing the budget into balance, and of closing this enormous deficit that we face again this year.

"Of course, there are those who will show you a paper projection, a computer run, and will try to demonstrate that if we can keep the rate of inflation high and allow the tax rates on businesses and individuals to continue to creep up, we will automatically . . . have a balanced budget. But that is pure mythology.

"That is only a computer projection. That is only a paper exercise that would never come true in the real world. We have had those forecasts made every year for the last 4 or 5, but as we have moved down the path toward the target year, these balanced budgets have seemed to disappear like the morning haze.

"There are reasons for that. The primary reason is that the tax burden today is so debilitating that it prevents the economy from growing, and without a growing economy we simply cannot hope to achieve a balanced budget."¹³

We hope that the essays herein will confirm this view and will give the reader not only a general understanding of what supply-side economics is all about but an introduction to some of the technical issues and current research on the subject as well. A selected bibliography for further reading is included at the end of this volume.

NOTES

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John A. Tatom

I. WE ARE ALL SUPPLY-SIDERS NOW!

John A. Tatom, a staff economist with the Federal Reserve Bank of St. Louis, uses a simple analytical framework to discuss the nature of supply-side economics, the supply-side effects of various government policies, and the implications of some supply-side policy proposals.

Consider a hypothetical society producing only two goods, X and Y. Then this society's production possibility frontier shows the maximum producible amount of X (Y), given some specified output of Y (X). This society will produce on its production possibility frontier if resources are fully employed, and if all resources are employed efficiently.

In Tatom's view, supply-side economics focuses on two aspects of this idea: First, economic policy directly affects the rate of growth of resource supplies as well as the pattern of innovation, thereby affecting the rate at which the economy's production possibilities improve. Second, economic policy can change the position of the current production possibility frontier.

The supply-side effects of various economic policies follow immediately. In the case of regulatory activity, efforts to control the exercise of monopoly power that may be limiting competition and/or technological innovation may promote efficiency. On the other hand, regulations that mandate the use of inefficient technology would adversely affect consumption possibilities.

The supply-side effects of government spending can also be explored using this framework. Suppose an increase in government spending is financed through an increase in taxes. Supply-siders emphasize that the increased taxes could reduce the total resources available, thereby reducing the society's production possibilities. This can occur when resource owners choose not to supply their resources to the market but instead to avoid the taxes associated with the rental or sale of productive resources. In addition, taxation may encourage resource owners to divert their resources to less efficient but lower taxed uses. Again, this would have the effect of shifting the society's production possibility frontier inward.

The analysis of the supply-side effects of transfer programs is similar. These programs have to be financed by increased taxes, increased government borrowing, or more rapid expansion of the money supply. Higher tax rates discourage work effort, saving, and investment. Government deficit finance (borrowing) "crowds out" private-sector investment, and money creation is inflationary.

This last point leads to a consideration of the supply-side effects of monetary policy. Too rapid money creation is inflationary, and inflation interferes with efficiency. Perhaps the clearest example of this is the employ-

ment of scarce resources to economize on the higher cost of holding money. In addition, inflation interacts with the tax code to discourage saving and investment. The principal characteristic of the tax code that creates supply-side disincentives in the presence of inflation is its basis on historical *nominal* accounting of income. As an example, inventory expenses and depreciation are computed on the basis of historical costs rather than on the replacement cost of the inventory or the equipment. Thus expenses are understated, profits are overstated, and tax liability is artificially inflated. The result is that investment in new plant and equipment is slowed, reducing the rate at which the production possibility frontier shifts outward.

Tatom believes that the Kemp-Roth tax cut proposal—to cut marginal tax rates 10 percent per year over a three-year period—and the 10-5-3 capital cost recovery system have become too tightly linked with the debate over supply-side economics. In his view these proposals do not come directly to grips with the real problem, namely, the taxation of nominal income. Instead, both proposals “are aimed at redressing the disincentive created by past inflation.” Moreover, neither proposal is, in Tatom’s words, a “path-breaking supply-oriented innovation.” He points out that experiments with these two types of tax changes were the “hallmark of the ‘New Economics’ of the sixties.”

Tatom’s examination of the supply-side record over the past thirty years leads him to the conclusion that “there appears to be no major deterioration in the economy’s aggregate supply until after 1975. . . . The factors cited by supply-siders that reduce resource availability . . . do not seem to have seriously impaired resource availability, at least not before 1975.” Moreover, he attributes much of the post-1975 deterioration of the supply-side to the rapid increase in energy prices.

Tatom concludes by suggesting that “supply-oriented policies could modestly affect resource availability, economic efficiency and growth.” He is singularly unconcerned with the objections raised by some in opposition to the Reagan administration’s supply-oriented Program for Economic Recovery. These objections center on the possibility that tax rate cuts accompanied by strict control of money growth will result in higher deficits, higher interest rates, and higher inflation. Tatom’s response is that the tax cuts envisioned by the administration are accompanied by spending reductions, the Kemp-Roth cuts in marginal tax rates are likely only to offset bracket creep over the next three years, and the experience surrounding the 1964 Kennedy tax cut and the 1975 tax cut “would not support the higher deficits/interest rates/inflation scenario.”

The latest sensation in the popular press and among policymakers is the discovery of “supply-side economics” and the exciting promise of supply-side policies.¹