CONSTITUTIONAL REFORM: A PREREQUISITE FOR SUPPLY-SIDE ECONOMICS

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A Political Post-Mortem on Supply-Side Economics

We no longer hear much about supply-side economics. Its strongest proponents have left the Reagan administration and those who remain appear to have little commitment to promoting its theories. It is easy to get the impression that supply-side economics was little more than a fad that emerged from the rhetoric of the 1980 presidential campaign and has since been discredited by experience.

But supply-side economics is not a fad. It is solidly grounded in a body of theoretical economics that has been developing for over 200 years.[1] Neither has supply-side economics been discredited by experience. The history of the United States provides compelling testimony to its effectiveness. The recent so-called failure of supply-side economics has been political, not economic. The post-mortem that this economic theory faces is being performed by a political process that can no longer focus beyond short-run concerns. Genuine supply-side policy is necessarily a long-run policy, and it is quickly rendered impotent by the policy reversals and uncertainties that characterize a political process that responds primarily to immediate, short-run imperatives. The historical success of supply-side economics will remain just that, history, unless we are able to reinstate genuine limits on the myopic motivations of political decision makers. It will be only with constitutional reform limiting political discretion that

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[1]See David G. Raboy, "The Theoretical Heritage of Supply Side Economics," in *Essays in Supply Side Economics*, ed. David G. Raboy (Washington, D.C.: Institute for Research on the Economics of Taxation, 1982).

supply-side policy will once again become the foundation for renewed economic growth and vitality.

Supply-Side versus Demand-Side

Stripped to basics, supply-side economics is simply a restatement of one of the most fundamental economic principles: Increase the relative return to engaging in an activity and there will be an increase in that activity. Of particular relevance to supply-side economics is the return to leisure and consumption relative to the return to production and investment. If the relative return to leisure and consumption is increased, people will produce less and attempt to consume more, which can be successful only in the short run. But if the relative return to productive activities is increased, people will substitute productive pursuits for consumption, which will lead to more consumption in the long run.

All governmental activities, whether spending money or raising taxes, have some effect on the relative return to different activities. For example, by reducing the cost of being unemployed, unemployment compensation increases the unemployment rate. Although concerned with all public policy and its effect on incentives, supply-side economics has concentrated primarily on the impact of taxation. To a supply-side economist, the importance of a change in taxes is in the resulting change in relative returns. The advantage in reducing the marginal tax rate on interest income is the increased incentive to save, which increases the potential for investment and long-run economic growth. There are similar advantages in reducing the marginal tax rate on income (the return to labor) and capital gains (the return to investment). In each case, the tax reduction may immediately increase take-home income and motivate taxpayers to spend more.[2] This short-run effect, however, is not the one that is of most interest to supply-side economists; they are more interested in focusing on productivity increases that necessarily require a long interval of time before they are fully realized.

Keynesian economics, which has dominated the macroeconomic policy perspective for decades, has also been concerned with the effects of governmental spending and taxing policy. From the

[2]It should be noted that a marginal tax rate can be reduced without lowering the average tax rate, so a marginal tax rate reduction may have no effect on spendable income. Also, even if a tax cut reduces total tax payments, it does not follow that there will be a positive income effect (an increase in real income) once the value of publicly provided services are taken into consideration. See James D. Gwartney and Richard Stroup, "Labor Supply and Tax Rates: A Correction of the Record," *American Economic Review* (June 1983): 446–51.

Keynesian view, however, the pivotal feature of governmental policy comes from its influence on the demand side of the economy. Keynesians focus on the gap between potential GNP (the value of output the economy is capable of producing) and actual GNP (the value of output actually being produced). When this gap is positive, the problem is seen as one of inadequate demand and the Keynesian response is for government to cut taxes or increase spending or both in order to increase the current rate of spending. Through a multiplier effect, Keynesians hold that a relatively small initial increase in spending can stimulate a large increase in demand and restore a depressed economy to its full productive potential. If demand exceeds the full employment potential of the economy, however, inflation will result; and the appropriate response is to combine tax increases and spending cuts to reduce demand.

The objective of Keynesian economic policy is to fine-tune aggregate demand in order to stabilize the economy and keep actual GNP as close as possible to potential GNP. The Keynesian orientation is relatively short run, emphasizing the near-term consequences of changes in spending and taxing decisions. Keynesians have paid little attention to the long-run effect of these decisions on the productive capacity of the economy. In contrast, supply-side economists emphasize that the real economic problem is pushing back the limits on our ability to produce, not encouraging consumption. There will be short-run fluctuations in demand, but over the long run if there is an increase in the goods and services produced, demand will keep pace. Unfortunately, increasing productive capacity requires sacrifice, effort, and time and, unlike demand-side policy, can do little to pump up the economy before the next election.

Politics and Patience

In evaluating economic policy it is important to recognize that democratic political processes are inherently myopic. The success of economic policy depends at least as much on political incentives as it does on economic incentives. The success of Keynesian economics, for example, was primarily political and had less to do with its theoretical soundness than with its tendency to cater to the shortsighted proclivities of the political process.[3]

[3]On the other hand, even if Keynesian economic theory had been completely sound, its success as economic policy would have been undermined precisely because it provided a rationale for politicians to do what they wanted to do all along: concentrate on short-run objectives. See James M. Buchanan and Richard Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

It is impossible to erradicate political myopia in a democratic political order. Some short-run political expediency is simply part of the price to be paid for the benefits that political democracy offers. But achieving the ideals of democracy does not depend on any particular institutional arrangement, and some arrangements can be expected to perform better than others.[4] Before returning to the challenge that political myopia poses for supply-side economic policy and considering possibilities for meeting it, a discussion of why political decision makers tend to concentrate on the near term and ignore the long term will be useful.

As individuals, politicians are much the same as anyone else. They are not inherently shortsighted and will take a long-run perspective if it is to their advantage to do so; otherwise, they will concentrate on the more immediate effects of their decisions. Politicians tend to be shortsighted because of the political incentive structure within which they operate. The most obvious inducement for politicians to focus on short-run consequences is provided by the desire to survive periodic elections. When considering alternative policy proposals, then, there is a tendency to exaggerate the importance of those results that will occur before the next election and to put less weight on post-election consequences. The politician whose policy recommendations provide long-run benefits far in excess of the costs is unlikely to receive credit if he is defeated at the polls because the cost was evident. On the other hand, a policy that provides immediate benefits will be attractive to a politician facing an election, even if the long-run costs (which may be hard to trace to the policies and politicians responsible) are far greater than the benefits.

It is not difficult to find examples that strongly suggest political sensitivity to pre-election outcomes. From 1950 (when the first major increase in social security benefits was legislated) through 1974 (after which cost-of-living adjustments have automatically increased social security benefits), the U.S. Congress increased social security benefits eleven times; eight during election years. Furthermore, in seven of the eight cases, the increase in social security taxes needed to pay for the augmented benefits was postponed until after the election. After social security payments, veterans' benefits make up the largest component of governmental transfers; and the most likely time to observe a surge in these benefits is shortly before elections. According to Edward Tufte, "Since 1962, Veteran benefits have increased

[4]For an elaboration of this point, see Friedrich A. Hayek, *Law, Legislation, and Liberty*, vol. 3: *The Political Order of a Free People* (Chicago: University of Chicago Press, 1979).

an average of $660 million (at annual rates) between the third and fourth quarters of election years, but only $220 million in years without elections."[5]

Recurring elections would not provide much explanation for myopic political decisions if voters were motivated to be informed and held their elected representatives accountable for the long-run consequences of their decisions. Giving voters the power to vote politicians in or out of office is based on the hope that politicians will respond to public concerns—concerns that surely include long-run considerations. But individuals have little motivation to acquire the information necessary to determine before the fact, or recognize after the fact, the long-term consequences of political decisions.

Informed and farsighted political decisions provide general benefits that are available to individuals whether or not they are informed and involved. In other words, being informed on broad political issues gives voters no more claim on the advantages of good public policy than is available to the uninformed.[6] It is quite rational, then, for people to remain politically ignorant and concentrate on being informed in areas where additional knowledge provides differential advantages.[7] Our well-being is surely influenced more by political decisions on major economic policy than by our choice of shoes. Yet, most people will be more informed on shoe fashions than they will be on the intricacies of economic policy.

Of course, the immediate consequences of a policy can often be associated with that policy without having detailed information or knowledge. But even the most informed citizen will generally find it difficult to anticipate the long-run effects of a policy or make the connection between effects and the policy responsible for them. The politician is fully aware of this problem and recognizes that he is much more likely to be held accountable for the near-term results of his decisions than for the long-term results, and he focuses his time perspective accordingly.

A pertinent example is the political popularity of inflationary policies. Expanding the money supply allows politicians to provide

[5]This example, along with the social security example, is documented in Edward R. Tufte, *Political Control of the Economy* (Princeton, N.J.: Princeton University Press, 1978), chap. 2.

[6]It is useful to think of sound public policy decisions as public goods. See Gordon Tullock, "Public Decisions as Public Goods," *Journal of Political Economy* 79 (July/August 1971): 913–18.

[7]This is not to deny that many people realize personal satisfaction simply from being informed on a broad range of political issues, but for most people it takes little knowledge to satiate their desire for political knowledge.

highly visible and immediate benefits that they can easily take credit for. Public projects can be financed, services can be provided, subsidies can be given, interest rates can be temporarily reduced, and employment can be temporarily increased by simply expanding the money supply. It is only after some lag that these benefits are paid for through higher inflation, a cost that is spread over the entire population. Politicians have been remarkably successful at shifting blame by convincing the public that inflation is the fault of labor unions, business profits, bad harvests, OPEC, or irresponsible consumer spending.

Another approach to explaining political myopia concerns a bias in political communication. It is easier for relatively small groups with narrowly focused concerns to organize and communicate their demands through the political process than it is for large groups with diverse concerns. This bias has allowed single-issue groups to use the political process to capture benefits at the expense of the general public. The result is a pattern of governmental expenditure and involvement that would probably not be chosen by anyone if judged as a complete package. Each special interest would likely see an advantage in moderating and deferring its political demands if similar moderation and patience would be exercised by all other interest groups. Unfortunately, since it is hard to arrange for well-defined private property rights in politically controlled resources, the information and incentives that come from market exchange are absent.[8] In the political process, individuals are unable to communicate their preferences in ways that encourage honesty and reciprocity.

When politically influential groups are able to exploit the political process for immediate gain, they realize that restraint will give them no preferential claim on future benefits in exchange. The "political capital" that would be generated by responsible fiscal decisions cannot be marketed because it is not private property. The politician who exercises the restraint necessary to maximize the long-run value of his contribution cannot realize this value at the end of his political career by selling his political capital. Similarly, constituents who contribute to the value of "political capital" by moderating their demands cannot benefit from their contribution.

[8]Politically controlled resources are usefully characterized as common property resources with control determined by the rule of capture. The problems that arise when resources are commonly owned are discussed by Garrett Hardin, "The Tragedy of the Commons," *Science* 162 (1968): 1243–48. For a discussion that deals specifically with the problem of politically controlled resources as common property, see John Baden and Rodney D. Fort, "Natural Resources and Bureaucratic Predators," *Policy Review* (Winter 1980): pp. 69–81.

Politicians, and the special interest groups that support them, are in much the same position as the American buffalo hunters in the 1870s. Each hunter knew that all hunters would be better off in the long run if everyone reduced the slaughter of the buffalo. In the absence of private ownership, however, each also knew that the buffalo he spared today would be shot by someone else tomorrow. Individual hunters found that there was little to gain but much to lose by taking a long-run perspective and exercising restraint.[9] Political decision makers also find that there is little to gain but much to lose if they neglect short-run demands on the economy, even though in the long run those demands will exterminate much of our productive capacity.

The Destructive Tax Trap

Given the shortsighted proclivities of unrestrained political action, it is possible to understand the obstacles to a genuine supply-side economic policy. In order to appreciate fully the political dilemma facing the supply-side approach, we must examine the shortsighted dynamics that have given us the destructive tax burdens that supply-side economists hope to alleviate. We find that it is extremely difficult to reduce destructive tax burdens even when they are widely recognized as such.

To make a convincing argument that the democratic process tends toward excessive tax burdens, a criterion for judging the appropriateness of the tax burden must be established. The criterion is conceptually straightforward, though difficult to apply in practice. Increasing taxes generates costs and benefits. When taxes are increased, the costs are measured by the value of the private production that is sacrificed, and the benefits are measured by the value placed on the public services that can be provided. Ideally, taxes should be increased until the value of the additional private productivity sacrificed is equal to the value of the additional public services provided. While it is difficult to know exactly at what point this balance is reached, some things can be said about the range within which the ideal tax burden is found. It is helpful to look at the tax rate–tax revenue relationship, popularly known as the Laffer curve.

Although there are many different taxes and tax rates, little harm is done at the conceptual level by talking as if there is but one relevant rate. The Laffer curve depicts the long-run relationship between this

[9]For many interesting details of the buffalo slaughter, see John Hanner, "Government Response to the Buffalo Hide Trade," *Journal of Law and Economics* 24 (October 1981): 239–71.

tax rate and the tax revenue that is raised. A representative Laffer curve is shown in Figure 1, where the tax rate is measured on the vertical axis and tax revenue is measured on the horizontal axis. Although the Laffer curve is the object of some controversy, its basic logic is obvious and unassailable.

If a tax rate of zero is applied to the tax base, it is clear that no tax revenue will be raised; therefore, the Laffer curve starts at the origin, or intersection, of the axes. If the tax rate is increased above zero, tax revenue will become positive. Over some initial range of tax rates, there are two reasons why increasing the tax rate will increase tax revenue. First, increasing the percentage of a given base that is taken through taxation increases tax revenue. Second, up to some point the tax revenue allows government to better protect private property rights and provide important public goods, which creates a favorable environment for productive economic activity and thus generates an expansion in the tax base.

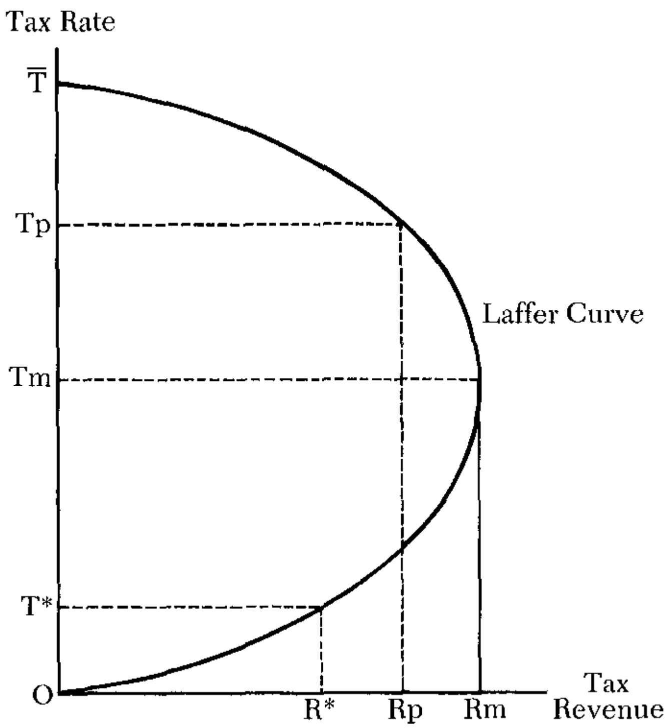

Figure 1
LAFFER CURVE

At some point, the disincentives to productive activity caused by an increase in the tax rate more than offset any positive effects from governmental activity, and the higher tax rate causes a reduction in the tax base.[10] Tax revenue will continue to increase with an increasing tax rate, however, as long as the percentage reduction in the tax base is not as large as the percentage increase in the tax rate. But there is a point where the tax base will decline enough in response to a higher rate so that increasing the rate will have no effect on tax revenue. This point occurs when the tax rate reaches T_m and tax revenue equals R_m in Figure 1. It is at this point that the government maximizes the revenue it receives from taxes. If the tax rate is increased above T_m, revenue will actually decline as the reduction in the tax base more than offsets the effect of the higher tax rate. At some sufficiently high tax rate, shown as $\overline{T}$ in Figure 1, tax revenue will fall to zero, since the tax burden has destroyed all incentive to remain productive, except possibly in the underground economy. No one knows exactly how high $\overline{T}$ is, but there can be no doubt that such a tax rate exists.

The controversy over the Laffer curve does not concern the existence of the rate-revenue relationship, but the question of where we are on it. Some enthusiastic supply-siders, sometimes known as Lafferites, have argued that we are on the upper half of the Laffer curve, with the effective tax rate exceeding T_m. In this view, a reduction in the tax rate would motivate such a large increase in productive activity that tax revenue would increase. Others have argued that taxes have not reached such destructive levels and that we are still on the lower half of the curve. Much of the popular discussion on supply-side economics has centered on this controversy and has left the impression that the case for supply-side economics depends on tax rates having been increased beyond revenue-maximizing limits. This is not the case. Supply-side economics claims that the tax burden has become *excessive* and that tax rates have increased beyond the point where the value the government can provide by an additional increase in taxes is equal to the resulting sacrifice in private production.

[10]The reduction in the tax base will occur both because some production will not take place at the higher tax rate than would have taken place at a lower rate and also because some production will be hidden from the tax authorities; that is, it will go underground. Although underground production is better than no production at all, such economic activity is generally less productive than if it were performed aboveground because of the resources and effort devoted to avoiding detection. For a discussion of the literature on the underground economy, see Carl P. Simon and Ann D. Witte, "The Underground Economy: Estimate of Size, Structure and Trends," *Special Study on Economic Change*, Vol. 5: *Government Regulation: Achieving Social and Economic Balance* (Washington, D.C.: Government Printing Office, 1980), pp. 70–120.

While we may never be able to pinpoint the ideal tax burden, we know that the ideal tax rate is reached well below the point where tax revenue is maximized; that is, tax rate T_m in Figure 1. Figure 1 demonstrates that the government gains no additional revenue with which to expand services if there is a marginal tax rate increase at T_m. On the other hand, this increase will reduce private sector productivity. Obviously, one does not want to increase the tax rate to the point where no benefits are received in return for the additional costs incurred. Tax rate T_m is excessive. The ideal tax burden is imposed at a tax rate, such as T^*, on the lower portion of the Laffer curve.[11] There are strong reasons for believing, however, that the democratic process exerts constant pressure toward excessive tax burdens, It is quite possible for politicians, responding to the incentives of ordinary politics, to actually increase the tax burden to the destructive levels represented on the top half of the Laffer curve.

Politicians obviously place a positive value on additional tax revenue. The more tax revenue available, the easier it is for politicians to satisfy the so-called urgent demands placed on them by politically influential interest groups. Of course, special interest groups do not have a free hand when it comes to acquiring governmental favors, since politicians are not insensitive to the political costs associated with raising taxes. But tax increases are spread widely over a politically unorganized public and can be made to appear largely independent of political decisions (e.g., inflation-induced bracket creep), while tax proceeds can be directed rather precisely to those coalitions and constituencies that have the greatest political influence. Therefore, the political costs of tax increases will be heavily discounted relative to the political gains from the additional tax revenue. This bias alone exerts tremendous pressure for an excessive tax burden. In an ideal world, the political benefit-cost ratio would mirror the social benefit-cost ratio, and politicians could only gain from raising taxes when the social benefits from doing so exceeded the social costs. Given the opportunities for maximizing political gains by concentrating benefits while minimizing political losses by spreading costs, however, the political benefit-cost ratio is distorted in favor of taxing and spending.

The tendency toward excessive tax burdens is accentuated by political myopia that causes politicians to see tax rate increases as more

[11]Somewhat surprisingly, some Lafferites have argued that the appropriate tax rate maximizes tax revenues. According to Jude Wanniski, for example, "This [the revenue-maximizing rate] is the rate at which the electorate desires to be taxed." See Jude Wanniski, "Taxes, Revenues, and the Laffer Curve," *The Public Interest* (Winter 1978), pp. 3–16.

potent sources of revenue than they really are. It must be recognized that there are long lags between the time a change in the tax rate occurs and the time when the effect of the change is fully realized. The existing stock of capital, whether physical or human, does not immediately diminish when the tax on the return generated is increased. Decisions to replace and expand these capital assets will be discouraged, but the productivity of those already in existence will depreciate only through time. Similarly, a tax cut will encourage decisions to expand investment, but the resulting increase in productivity and the tax base cannot be fully achieved immediately. Realizing the full impact of a tax cut requires time for investments in physical and human capital to be planned and implemented and to facilitate the production of new wealth.

These lagged fiscal effects produce a temporal asymmetry between increasing taxes and reducing them. Increasing tax rates will increase tax revenues more in the politically relevant short run than in the eventually relevant long run. Turning this coin over, a tax rate decrease will decrease tax revenues more in the short run than in the long run. The political bias this creates in favor of tax increases is obvious. Although much of the revenue gain derived from increasing taxes is temporary, it is temporary gains that fuel the political process. Tax increases that are obviously too high even from the politician's perspective, once their long-term consequences have been entirely realized, will still be enticing to myopic politicians. And even when long-run effects are realized, those politicians who inherit the unfortunate legacy of high taxes will have little incentive to reduce them. Even if a tax reduction would increase revenue in the long run, it could result in a significant revenue decrease in the short run, a consideration that would be politically controlling.

The Lafferites, in their enthusiasm for immediate benefits to be realized from a tax cut, have ignored the importance of the short-run/long-run distinction in the consequences of taxation. Ironically, it is this distinction that provides the theoretical support for their central claim—that reducing tax rates will increase tax revenues. If the impact of tax changes were as immediate as some Lafferites seem to indicate, it would be extremely difficult to argue that any government would increase taxes to the point of actually reducing revenues. If the government operated benevolently, concerned only with promoting the public interest, it would certainly not increase tax rates to the point of reducing tax revenues. To do so would impose an unnecessary cost on private production and reduce the government's ability to provide useful goods and services. At the other extreme, if the government operated as a revenue-maximizing Leviathan, concerned only with promoting the narrow interests of those with political power, it still would find no advantage in increasing tax rates above revenue-maximizing limits.

What makes no sense in the absence of fiscal lags, however, may be quite understandable once those lags are considered. The possibility that tax rates will be increased to a level that actually reduces revenues becomes plausible once the time dimension of fiscal impacts is recognized. Politicians, tempted by the transitional revenue gains from successive tax increases, may well continue to push tax rates up even when the long-run effect is to reduce revenues.[12] It seems quite likely that this is exactly what has happened in the United States and other western democratic countries. Effective tax rates have increased steadily, commonly with the help of inflation, even though the long-run consequence has surely been to impede economic productivity and possibly reduce tax revenues below what they would have been under more modest tax burdens.

Although economically destructive tax burdens may not have reached the point of reducing tax revenues, this possibility cannot be dismissed out of hand. The dynamics of short-run political expediency are capable of driving tax rates up to the point where cutting marginal tax rates would actually generate a long-run increase in tax revenue. Whether or not tax rates have ben increased into the upper half of the Laffer curve, there can be no reasonable doubt that the myopia of ordinary politics has imposed an excessive tax burden on the economy. Who can believe that the long-run gains in productivity that would be motivated by a permanent reduction in the tax burden would not exceed the long-run losses that might result from underfunding governmental programs?

In the case of the tax burden, how we got to where we are has important implications for the prospects of improvement. In travelling the shortsighted political path to excessive tax rates, expectations have been formed that will make it very difficult to reduce taxes. The reason goes beyond the obvious point that short-run revenue loss from reducing taxes will, in the minds of shortsighted politicians,

[12]This has been explored in James M. Buchanan and Dwight R. Lee, "Politics, Time, and the Laffer Curve," *Journal of Political Economy* 90 (August 1982): 816–19; and in *idem*, "Tax Rates and Tax Revenues in Political Equilibrium: Some Simple Analytics," *Economic Inquiry* 20 (July 1982): 344–54. In the first paper it is shown, assuming political myopia, that a strictly revenue-maximizing government will always move toward a political equilibrium where the tax rate is above that which maximizes long-run revenue. In the second paper, the objective of government is to maximize a generalized utility function in which tax revenue enters as a good and the tax rate enters as a bad. Staying with the assumption of political myopia, it is shown that political equilibrium may still call for a tax rate above the long-run, revenue-maximizing level.

outweigh the long-run economic benefits. Even genuinely farsighted politicians will find it difficult to reduce taxes once they have reached excessive levels.

The public has increasingly become aware that taxes are at destructive levels because of the short-run incentives that guide political decisions. As long as the public realizes that there has been no permanent restructuring of political incentives or no additional restraints imposed on the politician's ability to respond to short-run pressures, it quite rationally expects that any tax cut will be temporary. Investors will see an immediate, full-investment response to a tax cut as locking their wealth into a position that makes it vulnerable to the next tax increase.[13] The supply-side stimulus provided by a tax cut, which takes a long time under even the most favorable circumstances, takes even longer in the expectational environment created by a history of shortsighted governmental policy.

In this setting, even if a political administration wanted to take a long-run perspective, it would have difficulty implementing a permanent tax cut. There would be a reluctance to respond quickly and fully to tax cuts put into effect, even if investors had complete confidence in that administration. Given the short-run incentives facing politicians, the farsighted actions of such an administration would be seen as anomalies that would soon be reversed by politicians with more conventional time horizons. This investor reluctance would serve to undermine the resolve of the most resolute political tax-cutters. The delayed and timid supply-side response to tax cuts would create temporary shortfalls in tax revenues and activate strong political pressure against maintaining the cuts.

The 1981 Reagan tax cuts provide an example of the problem. In the case of income taxes, the Reagan cuts really were not cuts at all. They amounted to nothing more than a partial offset to inflationary bracket creep and increases in Social Security taxes.[14] Despite this, even before they went into effect, politicians in both political parties expressed concern that the Reagan "cuts" were not working, and there was significant political pressure to reverse the cuts. As a result,

[13]An example of the fickle nature of tax cuts that are supposedly motivated by the desire to prompt long-run commitments of investment funds is seen in the congresssional repeal, within a year of its enactment, of the law permitting companies to buy and sell tax benefits that arise from depreciation on capital investment. For a discussion, see "Uncertainty Cripples Tax Leasing as Law Makers Consider Change," *Wall Street Journal*, 5 April 1982, p. 25.

[14]See Steven A. Meyer and Robert J. Rossana, "Did the Tax Cut Really Cut Taxes?" Federal Reserve Bank of Philadelphia *Business Review* (November/December 1981), pp. 3–12.

in 1982 Reagan backed away from his pledge not to raise taxes and supported a successful move to offset the 1981 tax "reductions" with tax increases, euphemistically referred to as revenue-enhancing measures. Obviously these political pressures and reversals do little to generate the investor confidence needed for a genuine supply-side response to tax cuts.

Even if tax rates do reach the destructive levels represented by the upper half of the Laffer curve, it will be extremely difficult to reduce them. The transitional gains that activate the political process can lead us into a destructive tax trap and the hopes of supply-side economists can be frustrated. A supply-side response to tax cuts will not be quickly forthcoming unless the cuts are known to be permanent, and tax cuts will not be permanent unless they motivate a prompt supply-side response.

Constitutional Reform and the Resuscitation of Supply-Side Economics

Given the current political environment, genuine supply-side economic policy is effectively dead. Supply-side economic policy will never be given a real opportunity until politicians give serious consideration to the long-run consequences of their decisions. Yet, unless real constraints are imposed on the ability of politicians to respond to special interest demands, political decision making will continue to be dominated by short-run considerations. There is really no basis for blaming the politicians. Given the situation in which they find themselves, their behavior is perfectly predictable. As long as the only criterion for determining the legitimacy of a governmental action is the approval it receives from politically influential coalitions, politicians will be compelled to focus on short-run expediencies.

When unrestrained political power makes politicians the lackeys for organized special interests and special interests become the victims of the productivity-destroying excesses of their own short-run demands, there is the potential for all to benefit by accepting some self-denying limits on government. If politicians could honestly say to politically organized groups, "My hands are tied; I cannot provide more benefits to special interest groups by imposing additional costs on the public at large," then the scope for shortsighted political exploitation of one group by another would be reduced. A government that can credibly tell people that there are *clear limits* on how much of their productive efforts can be taken from them will be in a better position to encourage productive investment than will a government that cannot commit itself to such limits. The best and maybe the only hope for motivating a move away from parasitic transfer activities and toward productive, wealth-creating activities that will, in the long run, make everyone better off, is having constitutional limits on the scope of government.

The destructive tax trap discussed in the previous section provides a good example of the need for constitutional limits. Once the tax burden has reached destructive levels, there is little hope that permanent tax cuts can be achieved through the workings of ordinary politics. Even if the long-run effect of a tax cut would motivate an expansion in investment and productivity sufficient to actually increase tax revenues, politicians will be reluctant to cut taxes if the short-term effect is to reduce revenues. Because investors have learned to view the political process as shortsighted, they will be reluctant to make productive, long-term investments in response to any tax cut. This is a self-fulfilling expectation, as investors' reluctance to respond to a tax cut in ways that expand the tax base makes it extremely difficult politically to maintain such a cut. Without some resolution of this dilemma, everyone is worse off in the long run: Government has less revenue than it could have, and the private sector suffers from a higher tax burden and lower productivity than it needs to.

Escape from the destructive tax trap and a political resuscitation of supply-side economics require that government convince the public that it is not only cutting taxes, but cutting them *permanently*. This means convincing the public that current politicians will persist with a tax cut and, further, that the cut will not be rescinded in the future. It is here that the advantage of constitutional limits on the fiscal powers of government can be seen. Constitutional limits are a means to reach forward in time and control the behavior of future decision makers in a way that allows current decision makers to behave more responsibly. Consitutional restrictions that prevent future politicians from gaining short-run advantages by increasing taxes creates a setting in which current politicians can look beyond short-run concerns and focus on the long-run advantages of lower taxes. Durable limits on the ability of politicians to cater to the demands of organized interests by increasing the tax burden are essential if the political process is to lengthen its vision and provide supply-side economic policy a real opportunity to revitalize economic productivity.

The Prerequisite of Constitutional Change

In the 18th century the French political philosopher Montesquieu asked: "Will the state begin by impoverishing the subjects to enrich itself? Or will it wait for the subjects to enrich it by their own prosperity?"[15] In most countries during most of human history, Montesquieu's first question has received an affirmative answer. In the United States we have been fortunate in that our government has, until recent decades, been restrained against enriching itself by exploiting the productivity of its citizens. The result was years of savings, investment, and productive effort that created a prosperous population and a prosperous government as well.

In the broad sense, the founding fathers were supply-siders. They were not interested in governmental policy designed to maintain strong demand. Indeed, if such a policy had been suggested it would have been considered rather bizarre. The founders were confident that if goods and services were produced there would be a demand for them. In framing a constitution, they were interested in establishing a political structure that, among other things, would be conducive to productive activity. With the drafting and ratification of the U.S. Constitution, an experiment was put into motion for testing the effectiveness of supply-side economics. Government was severely restricted in its ability to use taxation and regulation to insert wedges between the value generated by an individual's effort and investment and the return the individual received. This also meant that it was difficult to use the political process to acquire wealth produced by others. In short, the Constitution established a political economy in which the return to productive activity was high relative to the return to nonproductive activity.

This supply-side experiment worked wonderfully. It did not, of course, produce an miracle overnight; but it did provide people with the motivation and freedom to pursue their objectives through hard work and investment. The result was a steady accumulation of human and physical capital and economic wealth. The constitutional limits on government made the policy of supply-side incentives the de facto economic policy of the United States for well over a century, and the long-run effects of this policy were unmistakably successful.

We have inherited an enormously productive economy from the effort and vision of those who came before us. Given this inheritance, it is clearly possible to do well in the short run by consuming the benefits of our productive potential while doing little to maintain it. This is exactly what we have been doing in recent years. Economic productivity was essentially stagnant during the 1970s, yet we increased the size of our houses; spent more on vacations, jewelry, and clothing; enjoyed shorter work weeks; and rapidly increased the

[15]Quoted in James Ring Adams, "Supply-Side Roots of the Founding Fathers," *Wall Street Journal*, 17 November 1982, p. 26.

amount we spent on governmental services, subsidies, bailouts, and regulations. The effects of policies that encourage consumption while assuming blissfully that productivity will take care of itself have become painfully apparent. Real GNP has grown little as the economy has oscillated between periods of high inflation and high unemployment; major industries with outmoded capital are being surpassed by their foreign counterparts; and government is taxing away more of our income while the quality of important governmental services, such as education and highway maintenance, is declining. In response to the pressures of short-run political expediency, we are squandering our nation's productive capacity. Almost surely our descendants will have less reason to thank us for our economic stewardship and foresight than we have to thank our ancestors for theirs.

The interest in supply-side economics was a predictable response to the problems that have arisen because of the neglect in maintaining our productive capacity. But no matter how well-grounded in sound economic theory supply-side policy is, it will not be able, by itself, to return the economy to productivity and health. As long as politicians have broad discretion in responding to organized interests there can be little hope that they will be able to take the long-run view required by a serious supply-side economic policy. An effective supply-side policy demands more than providing economic advice to politicians. It requires that we recapture the constitutional perspectives that led our founding fathers to place severe limits on the scope of political action and discard the prevailing, but naive, notion that wide-ranging governmental discretion guided by good advice is a force for social progress. It is essential that we broaden our perspective from that of those who James Buchanan refers to as "public-policy economists" to that of Buchanan's "constitutional political economists."[16]

One may debate the particulars of the proposed tax limitation, spending limitation, and balanced budget amendments to the Constitution. None of these proposed amendments is without fault, and none will solve all of our economic problems. But the support and discussion that has accompanied these proposals are healthy signs. People are recognizing that we have to look carefully at the fundamental rules that define and shape our political order if we are to address intelligently many of our current economic problems. This constitutional attitude is probably just as important as the details of

[16]See James M. Buchanan, "Alternative Perspectives on Economics and Public Policy," Cato Institute *Policy Report* 6 (January 1984): 1–5.

the proposed amendments. Recognizing the need for constitutional reform is an essential first step if such reform is to be successful and if the political post-mortem on supply-side economics is to prove premature.