IS "SUPPLY-SIDE ECONOMICS" ENOUGH?

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The Question and the Answer

My answer to the question—Is "supply-side economics" enough?—is simply that it is both too much and too little. This paper will elaborate the sense in which "supply-side economics" is an exaggerated answer to current economic problems, and the sense in which it falls short of providing an adequate solution to our economic ills. I shall contend that "supply-side economics," *as defined by the media and a small group of propagandists*, lacks the consistent analytical framework necessary to provide effective solutions for our socio-economic problems. On the contrary, "supply-side economics" has contributed to the tactical difficulties encountered by the Reagan administration in executing its economic program. My assessment of "supply-side economics" is based on an examination of the problems we have inherited from past economic policies, and on the answers to these problems suggested by sound economic analysis.

The Inheritance

The period from 1950 to 1980 exhibits two very different phases. Over the first 15 years inflation was systematically contained. Output and employment increased at a healthy pace, and there was no sign of the dreaded stagnation widely expected at the end of World War II. The high point of this period was the subperiod 1960–1964, characterized by an essentially stable price level, stable and low interest rates, and steady economic growth.

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The pattern changed with remarkable force over the second phase of the postwar period. During the years 1966 to 1980, we drifted into a permanent inflation with erratic and high levels of interest rates. The system of fixed exchange rates erected at Bretton Woods collapsed and the dollar declined relative to most major currencies. Moreover, even though employment was growing, the average level of real growth fell substantially below the norm prevailing for many years. And the normal rate of unemployment rose gradually over time. Shifting conditions beyond policy may have shaped to some extent this evolution. Whatever these conditions may have been, the change in monetary, fiscal, and regulatory policies occurring over the postwar period crucially determined the difference between the two such periods. It became inceasingly clear that our policymaking required a new direction. "Supply-side economics" appeared in the media and political markets in response to the inherited problems. Unfortunately, it offered at best only a partial answer and actually obscured important issues.

Supply-Side Doctrine

The views characterizing "supply-side economics" emerged from the interaction between the media and a small group of advocates (Arthur Laffer, Jude Wanniski, Paul Craig Roberts, Alan Reynolds, and Robert Bartley), who found a powerful voice in Congress (Jack Kemp).[1] Some members of this group are not economists and know little economics. Some have a degree in economics, but none have a strong record of professional work. Indeed, their disinterest in academic work is compensated by their preference for demogogic exercises in the media and political arena. These facts need emphasis because the media has presented "supply-siders" as a major intellectual and revolutionary force in economics. Such a characterization has affected members of the intelligentsia and social scientists unfamiliar with economic history and analysis.

The basic doctrine accepted by "supply-siders" can be summarized as follows. A lower tax schedule and, especially, a lower slope of the tax schedule is a *necessary* and *sufficient* condition for economic recovery. "Supply-siders" claim that such a tax policy will increase real economic growth, eliminate inflation, and eventually lower government expenditures. They reason that lower effective marginal tax rates raise the willingness to work, save, and invest.

[1]The emergence of "supply-side economics" is treated in Paul Blustein, "Supply-Side Theories Became Federal Policy with Unusual Speed," *Wall Street Journal*, October 8, 1981, pp. 1, 16.

Indeed, they claim that the incentive effect of lower tax rates will be so strong that within one or two years output will grow *persistently* at record levels, greatly enlarging the tax base.

"Supply-siders" expect the large increases in economic growth, *assumed* to result from tax-rate cuts, to reduce the rate of inflation "without any tears" and without any recession. Lastly, "supply-siders" believe that the energies unleashed by lower tax rates will reduce the growth of social welfare expenditures. They claim that the revolution in output growth, brought about solely by tax policies, will raise living standards to such an extent that social welfare programs will become increasingly unnecessary. Thus, whatever the initial size of the federal deficit, it is forecast to ultimately disappear under "supply-side economics."

Economic Analysis and "Supply-Side Economics"

Contrary to suggestions emerging from the media and the intelligentsia, the basic tenets of "supply-side economics" have a long history, dating back to Adam Smith.[2] In particular, the "classical economists" emphasized the importance of low tax rates for economic growth. It was not until the "Keynesian abberation" that economists and policymakers began to neglect important supply-side responses to changes in relative prices, occasioned by tax and regulatory policies. In this regard, it is worthwhile to recognize that the Keynesian emphasis on demand management, which overlooks the array of incentives and disincentives operating on the supply side, does not represent the core of economic analysis.

Certain economists writing in the 1950s and early 1960s recognized the weaknesses inherent in the Keynesian macroeconomic approach to policymaking. These economists sought to return economic policy to its microeconomic foundations. Arnold Harberger, in particular, conducted important studies on the efficiency losses caused by various taxes.[3] He sought to minimize the excess burden of the tax system by selecting those taxes that have the least distortive

[2]For a historical treatment of supply-side theory, see Robert E. Keleher and William P. Orzechowski, "Supply-Side Effects of Fiscal Policy: Some Historical Perspectives," Working Paper Series, Federal Reserve Bank of Atlanta, August 1980.

[3]See especially, Arnold Harberger, "Taxation, Resource Allocation, and Welfare," in *The Role of Direct and Indirect Taxes in the Federal Revenue System* (Princeton, N.J.: Princeton University Press for the National Bureau of Economic Research and the Brookings Institution, 1964); "The Measurement of Waste," *American Economic Review*, May 1964, pp. 58–76; and "Corporation Income Taxes," in *International Encyclopedia of the Social Sciences*, vol. 15, part III (New York: Crowell Collier, 1968), pp. 538–545. All three articles are reprinted in his book *Taxation and Welfare* (Boston: Little, Brown & Co., 1974).

effects on relative prices and economic behavior. Thus, the range of incentive/disincentive effects produced by fiscal policy via supply-side effects forms a well-established body of economic analysis. One need only examine any contemporary public finance textbook to discover this fact.

In contrast, the assertions of "supply-siders" moved well beyond the acceptable arguments provided by traditional economic analysis. Besides overstating the supply-side effects of specific taxes, the "supply-siders" omitted important supply-side effects from their analysis. In so doing, they offered the public a wildly exaggerated and seriously incomplete answer to our inherited economic problems.

One of the "supply-siders' " most serious omissions has been their lack of attention to the supply-side effects of expenditure programs. The trend in unemployment cannot be adequately explained by changes in marginal tax rates, since it was conditioned by the interaction between tax rates and specific federal spending programs. "Supply-siders" seem only to have focused on the incentive effects of tax policies, while ignoring the level and composition of federal expenditures. As such, they have conveyed a faulty sense of the real burden imposed by the government's fiscal operations.

Another serious flaw of "supply-side economics" is revealed by the "supply-siders' " claim that the output effects of tax reductions will naturally shrink the public's demand for social welfare programs. This assertion fails to recognize the peculiar combination of incentives and disincentives characterizing these programs, and their effect on the use of resources. Most importantly, this assertion exhibits a remarkable naïveté concerning the nature of the political process shaping these programs.

The exaggerations advanced by "supply-siders" have centered around the output effects alleged to result from reductions in tax rates. "Supply-siders" project a rate of real growth substantially exceeding past growth rates, without any modification in expenditure programs and regulatory policies. Such projections have no sound analytical basis and cannot be supported by past experience. Similarly, the "supply-siders' " contention that inflation can be curbed without holding monetary growth to a low level cannot be supported either in theory or fact. Even so, Congressman Kemp continues to claim that inflation can be overcome at little (or no?) social cost by radical reductions in tax rates and a massive monetary expansion.[4]

[4]Representatives Jack Kemp (R-N.Y.) and Trent Lott (R-Miss.) recently (September 1982) introduced a bill to change the focus of monetary policy from targeting the growth of the money supply to targeting real interest rates. Their bill, the "Balanced Monetary Policy and Price Stability Act," if implemented, would undoubtedly lead to excessive monetary growth and accelerating inflation.

Beyond "Supply-Side Economics"

"Supply-side economics" suffers as an answer to our inherited economic problems because it fails to address the pattern of policy-making increasingly exercised over the past decades by Congress, the bureaucracy, and the courts. This pattern produces an ever-expanding growth of the state with an increasing range of social coordination by means of political institutions. In this context, the fine-tuning of economic policies characterizing a Keynesian tradition is but a special case of the general trend observed in Western nations. Meanwhile, the budget battle reflects a protracted conflict over the future shape of our society. The outcome of this battle will determine whether man will live under the tyranny of an unlimited government or in a society in which government is limited by a new constitutional consensus expressed by specific institutional arrangements.

The "institutionalization" of monetary and fiscal policy, discussed in the President's 1982 *Economic Report,* prepared by the Council of Economic Advisers, describes some aspects of the fundamental issues confronting us. Neither "supply-side economics" nor "supply-side policies" will solve the central problem of our time—the ever-expanding power of government. Our concern should be directed toward the creation of a stable and predictable institutional framework relying dominantly on markets for social coordination in order to effectively limit the government's activities. In particular, a new set of rules for the socio-economic game should be formulated, rules that prohibit the activist expansion and increasing exploitation by government officials of the political institutions in order to redistribute income and shift the control of economic affairs.

To effectively constrain government, we recommend the following policy actions:

1. *Monetary Control.*[5] The control and removal of inflation requires foremost an adequate and determined control over monetary growth. If relative prices are to perform their information and incentive functions effectively, there must be monetary stability so that erratic money does not upset economic calculation. A strategy of monetary control has traditionally been opposed by our Central Bank, and this tradition has contributed to the drift into permanent inflation. Monetary control seemed to have been accepted for a short while by the Federal Reserve authorities as a strategy to lower the rate of inflation.

[5]For a more detailed discussion of monetary control, see Karl Brunner, "The Control of Monetary Aggregates," in *Controlling Monetary Aggregates, III*, Proceedings of a conference sponsored by the Federal Reserve Bank of Boston, October 1980 (Boston: Federal Reserve Bank of Boston, 1981).

But the tactical procedure remains inadequate and reinforces the market's uncertainty about the underlying monetary strategy. The Fed's recent policy was to target the various measures of the money supply, but the lack of any enforceable monetary growth rule means that the Fed can, in fact, pursue *any* money-growth target it desires. Such an institutional setting obviously breeds uncertainty, and the granting of such enormous power to an independent government agency is certainly not consistent with the principles of a free society. The Reagan administration has done little to change this feature of our economic system. Instead of pursuing the stable money growth called for at the beginning of the Reagan administration, the Fed's control of the money supply has been more erratic than ever. This monetary erraticism, in turn, has led to a wild gyration in interest rates and has made rational investment planning extremely difficult.

2. *Deregulation.* In order to stimulate economic growth, the government must significantly reduce its controls on market activities, and recognize the possibility of "government failure." Moreover, regulatory policies should weigh the social costs of regulation more systematically against the expected benefits. In the past, policymakers typically have ignored the burden imposed on society by regulatory programs. Consequently, regulation has obstructed the efficient use and productive development of our resources. A systematic reexamination of these policies and a move toward less regulation form an important component of any useful recovery program. President Reagan has called for less regulation and a more careful weighing of the costs and benefits of regulation. However, his administration has done relatively little to mitigate the adverse effects of regulation in such areas as trucking, airlines, natural gas, and numerous other areas.[6]

3. *Budget Constraints and Lower Taxes.* The expanding size, both absolutely and relatively, of our federal budget is our central problem. It creates incentives to use resources in the political process for the nonproductive, negative-sum games of redistribution. It creates large disincentives for the suppliers of labor, capital, and natural resources, and it produces serious distortions in the uses of our resources. Tax schedules and expenditure programs must both be substantially modified. Ultimately, the magnitude of the budget must be firmly controlled in order to change the incentives (or disincen-

[6]On the general regulatory climate under the Reagan administration, see Walter Guzzardi Jr., "Reagan's Reluctant Deregulators," *Fortune*, March 8, 1982, pp. 34–40. On transportation regulation, see Thomas Gale Moore, "Deregulation and Re-Regulation of Transportation," *Policy Analysis*, Cato Institute, Washington, D.C., July 8, 1982.

tives) in a direction which will improve the use and future development of human and non-human capital.

We should clearly recognize at this stage that the general policies required for President Reagan's economic program are well founded in economic analysis. This is certainly true for monetary policy and the approach to regulatory agencies. It also applies to the budget. However, we must emphasize that the real burden of government is reflected by the size of the budget, not by the explicit tax burden. Moreover, we must remember that the effect of regulatory policies and court decisions on private actions is to add to the true cost of government. Regulatory agencies, for example, may have relatively small budgets, but their impact on economic freedom and allocational efficiency can be substantial.

In order to lower the real burden of government we need to trim and restructure expenditure programs. Government should return to its traditional role of safeguarding person and property. Individual responsibility is better fostered by private ownership rather than by government intervention, ever-expanding social welfare programs and "public control" over resources. "Supply-siders" like to ignore these hard facts, and in so doing distract the public's attention from the fundamental issue—shrinking the size of government. What we want is not to increase the revenue of government by cutting tax rates, but to limit spending and the power to tax so that the private market economy can once more function efficiently to produce what consumers want. With government spending at an all-time high as a percent of GNP, we cannot afford to engage in "supply-side" dreaming. The time for fundamental constitutional reform is upon us.

By adopting a legislated monetary rule, by relaxing economic regulation, by adopting a constitutional amendment limiting the size of government, and by restructuring the federal budget to focus once again on protecting person and property instead of a massive and open-ended redistribution, we can unleash the supply-side responses desired by "supply-siders," and generate a new burst of economic growth and well-being.