

# *Supply-Side Economics: A Return to Basic Principles?*

E. C. PASOUR, JR.

THERE IS a growing consensus that the Keynesian doctrines which have dominated public policy for a generation have contributed little toward a solution of current economic problems. Indeed, there is mounting evidence that Keynesian economic policies have contributed to current problems of inflation, unemployment, low capital investment, reduced economic growth, and a rapid rise in the "underground economy." As the disenchantment with Keynesian economics increased in the late 1970's, supply-side economics received increased attention and it has occupied center stage in the political arena since the November, 1980 elections. However, supply-side economics has received widely mixed reviews by economists, political analysts, politicians, and the news media since Congressman Jack Kemp began to discuss supply-side incentives in the mid-1970's. Some observers, focusing on the effects of positive economic incentives, have interpreted supply-side economics to be merely a return to classical economic principles.

In the view of other critics, the approach is best described as "Voodoo economics." Some of the Kemp-Roth tax cut advocates, for example, have seemed to suggest that the reason for tax cuts is to cause real output to grow faster than government spending.<sup>1</sup> In this view, tax cuts are a means to more tax revenue to finance current or even higher levels of government spending. The relative unconcern of some supply-side enthusiasts about the level of government spending and the implication that a reduction in tax rates will increase tax revenues relative to expenditures and reduce budget deficits led Milton Friedman and others to describe the Kemp-Roth tax cut bill as a

"free-lunch" proposal. The purposes of this essay are threefold: (1) to explain the principles behind supply-side economics and the importance of distinguishing between tax rates and tax revenues; (2) to explain the relationship of supply-side economics to Keynesian economics; and (3) to place supply-side economics in historical perspective.

## *Supply-Side Economics*

SUPPLY-SIDE ECONOMICS stresses tax rate incentives rather than growth of the federal budget to stimulate productivity and economic growth but this emphasis, rooted in the ideas of Adam Smith and other classical economists, has a long history.<sup>2</sup> Smith, James Mill, David Ricardo and J.S. Mill emphasized the importance of positive incentives on saving, investment, and capital formation. Widespread acceptance by the classical economists of Say's Law — "supply creates its own demand" — reflected an emphasis on production and aggregate supply or output. The underlying premise of Say's Law is that people produce in order to consume. Further, since increased output will increase purchasing power and create demand of equal value, it was held that any shortfall of demand would be temporary. The classical writers also emphasized the relationship of high tax rates to circumvention through smuggling, fraud, and evasion (the "underground economy") and it was explicitly recognized that high tax rates may erode the tax base. In the words of Adam Smith:

High taxes, sometimes by diminishing the consumption of taxed commodities, and sometimes by encouraging smuggling, frequently af-

ford a smaller revenue than what may be drawn from more moderate taxes.<sup>3</sup>

Few prominent academic economists have contributed to the current revival of the supply-side movement. Arthur Laffer of the University of Southern California is a notable exception. The movement initiated by Kemp and Laffer has been popularized by a number of columnists including Paul Craig Roberts and Irving Kristol in the *Wall Street Journal*, by Tom Bethell in *The National Review*, by Jude Wanniski in his book devoted to supply-side ideas, *The Way The World Works*, and, most recently, by George Gilder in *Wealth and Poverty*.<sup>4</sup>

The basic idea of supply-side economics is that increased tax rates deter economic activity, drive it underground, or cause it to switch into legal but untaxable outlets. In stressing the relationship between tax rates and incentives, supply-side economics represents a return to classical economic principles which were downplayed for a generation after the Keynesian revolution in economics of the mid-1930's.<sup>5</sup> The significance and awareness of the importance of increased tax rates on human action increased during the 1970's as inflation and a progressive income tax intensified the effects of "bracket creep." Whereas only 2.9 percent of taxable returns faced a 25 percent or higher marginal tax rate in 1960, this figure had increased to 38.2 percent by 1976.<sup>6</sup> There is an increasing recognition that increasing tax rates affect incentives and responses of taxpayers generally and not just people in "high" tax brackets.

Tax incentives reduce productive output and manifest themselves in a number of ways.<sup>7</sup> First, as tax rates increase, people substitute leisure for productive market effort in a variety of ways including longer vacations, less overtime work and earlier retirement. Second, increased tax rates cause people to reduce the amount of productive market exchanges. A lawyer, in a 60 percent tax bracket, for example, may paint his own house and engage in other

work activities outside his area of comparative advantage. Third, an individual may be induced to substitute tax deductible for preferred nondeductible goods. For the individual in a 70 percent marginal tax bracket, the personal cost of a \$5,000 tax deductible vacation would be only \$1,500 since the tax liability would be reduced by \$3,500. Fourth, increasing tax rates mean that more and more valuable resources are devoted to the tax shelter industry. Tax lawyers, accountants, and investment consultants assist physicians, lawyers, teachers, electricians and other tax-payers in finding ways to reduce their tax liability.

Finally, high marginal tax rates erode the moral basis of the tax system and increase the incentive to evade taxes.<sup>8</sup> In the U.S., Sweden, Italy, and other countries, increasing tax rates have been accompanied by an increasing amount of economic activity in the "underground economy" where the exchange of goods and services is "off the books" and not subject to taxes. According to Gunnar Myrdal: "The tax system is turning Swedes into a gang of hustlers...the present tax system is making nine out of ten Swedes criminals."<sup>9</sup> Similarly, in Italy where marginal tax rates are also high it is estimated that between one-fourth and one-third of national income is produced in the underground economy.<sup>10</sup> The phenomenon of avoiding taxes by working in the unobserved sector is not restricted to Europe. A recent study estimated that unreported transactions in the U.S. are large and growing rapidly.<sup>11</sup> The rise of the underground economy is likely associated with rising marginal income tax rates resulting from progressive tax rates, inflation, and the consequent "bracket creep."

The contention that tax rates affect individual choice and, hence, human action does not suggest that people respond *only* to economic incentives. It does suggest that given income, other prices, and tastes and preferences, the demand curve for a particular good or service is downward sloping. If price of a good increases, other factors constant, people will consume less of the good. An increase in tax rates

represents a change in relative prices—the price of work is increased and the price of leisure is decreased. Thus, as the price of work increases relative to the price of leisure, individuals will (to some unknown extent, highly variable between individuals) substitute leisure for work. Taxes then affect individual choices—choices between work and leisure, between market and non-market activity, and between consumption and saving. Hence, as tax rates increase, individuals make adjustments in a variety of ways.

In the supply-side approach, high tax rates are considered to be barriers to production and a key idea is the relationship between changes in tax rates and tax revenue. When tax rates are near zero, it is argued, necessary public services, (e.g., law and order) could not be provided and output would be low.<sup>12</sup> As tax rates increase to provide essential public services, economic activity expands and tax revenues increase. At low levels of taxation, increases in productive efficiency outweigh any disincentive effects of higher tax rates. As tax rates increase, however, the disincentive effects become more important and “at some point, the loss in revenue due to the reduction in incentives, as well as the increase in tax avoidance, overwhelms the increase in tax rates, and, consequently, tax revenues peak and begin to decline.”<sup>13</sup> Thus, when tax rates are high, lower tax rates can so stimulate business and shift income from shelters to taxable activity that tax revenues increase.<sup>14</sup> The conclusion is that the effect of tax rate reductions depends critically upon the current level of taxation and can lead to either increases or decreases in tax revenue. No one knows what the effect of a decrease in U.S. tax rates would be under current conditions, but Laffer and others contend that tax revenues would increase. A similar relationship between tax rates and tax revenues also applies in the case of individuals. Thus, when the tax rate for an individual taxpayer is raised above some level, the result will be a reduction in taxes paid. Consequently, an across-the-board

cut in tax rates is likely to have a larger effect on the “rich” than on the “poor.” That is, such a tax cut may increase tax collections from the “rich” while decreasing tax collections from the “poor.” In this case, tax cuts are a painless way of “soaking the wealthy,” or in Gilder’s words, “...to help the poor and middle classes, one must cut the tax rates of the rich.”<sup>15</sup> One source of confusion concerns the significance of the pattern of tax rates which maximizes tax revenues collected by the government. Although Laffer explicitly states that tax rates which maximize tax revenue are not optimal, Wanniski considers the largest amount of tax revenue as “the point at which the electorate desires to be taxed.”<sup>16</sup> The pattern of tax rates which results in maximum government revenues, however, is inconsistent with the classical limited role of government.

#### *Historical Examples*

THERE IS A GREAT deal of uncertainty concerning the effect of reductions in tax rates, but a number of historical examples have been cited as precedents in arguing that a decrease in current U.S. tax rates would increase tax revenues.<sup>17</sup> An early example cited is that of Great Britain from the 1840’s to the 1880’s, a period of high taxes and economic stagnation. A reduction of tax rates in this era, engineered by William Gladstone, led to rapid economic growth and eliminated budget deficits.<sup>18</sup> Another example is that of the United States after WWI. Marginal income tax rates no higher than 7 percent in 1913 had increased to a top rate of 73 percent by 1921. Andrew Mellon, using arguments similar to those of today’s supply-side advocates, recommended decreases in tax rates to increase output, growth, and tax revenues. The maximum tax rate was cut to 55 percent in 1922 and to 25 percent in 1926, and these reductions appear to have contributed to the rapid economic growth of that era.<sup>19</sup> Not only did the economy benefit, but the millionaires themselves paid three times as much in taxes at lower tax rates.<sup>20</sup>

The tax cut of 1964 provides another ex-

ample of tax cuts which increased tax revenues. Congress reduced the corporate tax rate to 48 percent and enacted a 14 to 70 percent personal rate schedule in February 1964—a 20 percent average cut.<sup>21</sup> Tax revenues began to increase soon after the decrease in tax rates and, measured in dollars of constant purchasing power, annual tax revenues from both corporate and income taxes rose faster during the 3 years after the tax cut than during the 3 years before the reduction.<sup>22</sup> Although revenue increased in tax brackets as low as the 26 percent marginal rate (which was cut to 22 percent) in the 1964 tax cuts, the effect on incentives at that time and now is greatest where taxes are highest; *i.e.*, at upper income levels.<sup>23</sup> Thus, maintaining high marginal tax rates in upper tax brackets to “save revenue” may, in reality, be counterproductive.

#### *Supply Side versus Keynesian Economics*

WHILE THE supply-side approach represented economic orthodoxy prior to the 1930's, since that time the Great Depression has been taken as irrefutable evidence of the failure of classical economic theory. Moreover, for the past generation, the conventional wisdom has held that the economic problems of excess capacity and idle resources characteristic of that era were solved or alleviated by the “new economics” of John Maynard Keynes.<sup>24</sup> A brief review reveals how completely the accepted truths of the classical economists were supplanted by Keynesian theory. First, there was a rejection of Say's Law.<sup>25</sup> The existence of unemployment and unsold goods was considered to be *prima facie* evidence that supply does not create its own demand. According to the new conventional wisdom, not all of the income earned by people in a given period will necessarily be spent. If consumers “save” some of their income, all of the goods produced in a given period will not necessarily be purchased resulting in reductions in production and “involuntary unemployment.” Thus, in solving output and employment problems, Keynesian fiscal policy was directed toward increasing

and stabilizing aggregate demand. In its stabilization policies, Keynes “...believed that the state would take a long view and would not be influenced by short term changes in economic activity.”<sup>26</sup> At the same time, there was a shift in emphasis from the effects of taxes on incentives, production, and economic growth to the use of taxes to redistribute income. Keynes favored income redistribution on the grounds that it increases spending.<sup>27</sup>

A second important change was the shift in emphasis from production and supply to aggregate demand.<sup>28</sup> Say's law was replaced by Keynes Law—“demand creates its own supply.” Keynesian theory assumes that as long as total demand is adequate to achieve full employment, there is no need to worry about incentives to save, invest, or engage in entrepreneurial activity. If consumers spend more, more goods and services will be produced. Thus, the effect of tax rates on incentives, factor supplies, and growth was largely ignored. Moreover, if production is taken for granted, income distribution can be considered apart from production. And, for a generation, egalitarians have stressed that the tax system should be progressive to make the rich pay more. A third feature of the Keynesian or aggregate demand approach concerns the implications of a “shortage of demand” in terms of savings and capital formation. In the Keynesian approach, shortages of demand are caused by too little spending; *i.e.*, by too much saving; consequently, saving is antisocial or harmful. Indeed, the “paradox of thrift” still occupies a prominent place in college courses in macroeconomics.<sup>29</sup> The paradox of thrift holds that the intention of firms and households to increase savings may be frustrated by the resulting decrease in production and income. That is, Mr. Smith alone can increase savings. But, if many households make the same decision at the same time, the level of consumer expenditures will decrease resulting in a decrease in the production of goods and services so that the net result might be a reduction in employment and in savings. It is a Keynesian legacy that saving typically represents

an increase in money balances. The implication is drawn that saving is bad because savings are sometimes not invested. The problem, to the extent that there is a problem, of course, is not with saving but rather that the saving by Smith (and other individuals) is not invested (or spent by other consumers). Indeed, there cannot be investment if there is not first saving. Since saving is a necessary prerequisite for investment, the paradox of thrift doctrine to the extent that it has discouraged saving has contributed to current economic problems related to the rate of saving, capital formation, productivity and growth.

A fourth facet of Keynesian economics is the belief in the inherent instability of the market and stress on use of government policies to correct "market failure." The conventional wisdom is that a market economy is inherently unstable and that the massive economic contraction of the 1930's happened without a cause. It is only recently that a number of writers have marshalled a host of evidence showing that the Great Depression was not caused by "market failure" but rather represented the predictable consequences of government policies which ignored the lessons of classical economic theory. When the actions of government are taken into account, the Great Depression can more accurately be described as an example of "government failure" rather than that of "market failure." Consider the prevailing conditions in the 1930's—a large unemployment problem, gluts of agricultural and manufactured goods, low amounts of private investment, and a rapidly falling price level (deflation)—and the governmental actions taken which induced or exacerbated these problems. The Smoot-Hawley Tariff Act raised import duties to the highest levels in U.S. history. The consequences for domestic prices and U.S. exports of agricultural products were predictable. Farm exports were reduced by two-thirds from 1929 to 1933, and farm loans turned bad as product prices decreased.<sup>30</sup> The Federal Reserve, moreover, exacerbated financial conditions by

decreasing the money supply by one-third during the same period.

Government policy toward wages and product prices were equally counter-productive. The classical view is that a surplus of any good or service is caused by price being arbitrarily held above the market clearing level. Yet, with the unemployment rate ranging from 15-25 percent from 1931-1939 (and exceeding 20 percent from 1932-1935), the government actively resisted downward adjustments in wages and prices.<sup>31</sup> President Hoover first jawboned to keep wages up. The NRA (National Industrial Recovery Act) of the New Deal prevented wages and prices from falling through shorter working hours, minimum wages, and price fixing. Although the Supreme Court ruled that the NRA was unconstitutional in 1935, other New Deal legislation followed which reduced the work week and imposed minimum wages.<sup>32</sup> The net effect was that the real wage rate rose 4 percent from 1929 to 1933 and 27 percent from 1933 to 1937.<sup>33</sup> Thus, the severe unemployment problem was a predictable effect of ill-conceived governmental policies. Furthermore, the policies were inconsistent. Although high tariffs reduced exports and decreased product prices, governmental measures such as the NRA and the deliberate destruction of agricultural crops were taken to hold prices up.

In the tax area, as well, the harmful results of government policy were fully predictable on the basis of classical theory. In 1932, the Hoover Administration put through the biggest percentage increase in taxes in peacetime history. This was followed by a New Deal tax policy more concerned with the redistribution of wealth than with raising revenue as President Roosevelt hiked taxes in 1935 and routinely thereafter.<sup>34</sup> By 1938, the corporate tax rate had gone from 11 to 19 percent and the top income tax rates from 24 to 79 percent.<sup>35</sup> Thus, in the tax area (as in other areas) the policies followed could hardly have been better devised to stifle initiative and encourage economic stagnation. Finally, the conventional wisdom is that in-

vestment remained low even when interest rates were reduced to very low levels during the Great Depression—a violation of classical doctrines which suggests that a decrease in interest rates will increase investment. There is a great deal of evidence that investment was low during the 1930's, however, not because of excessive savings but because *real* (as opposed to nominal) interest rates were high.<sup>96</sup> Short term business loans in major cities, for example, were 4.7 percent in 1932. Since prices fell by 11.2 percent in 1932, the *real* interest rate was roughly 16 percent. Thus, the interest rate prevailing in 1932 was equivalent to a nominal rate of about 30 percent at today's rate of inflation. Moreover, in this period of falling prices government policies were antithetical to investment as the discount rate was hiked by 2 percent in 1932 and monetary policy was tightened again in 1937 with increases in the discount rate and reserve requirements. The low rate of investment is no mystery in view of the combination of high interest rates and New Deal antipathy toward business.

#### *Failure of Aggregate Demand Approach*

DESPITE THE abundant evidence that the Great Depression was caused by tariffs, taxes, monetary mismanagement, and political manipulation of wage rates and prices, the Keynesian aggregate demand theory reigned supreme by the end of the 1930's and has represented economic orthodoxy since World War II. During the 1970's, however, there was increasing recognition not only that government is incapable of "fine-tuning" the economy but also that current unemployment, inflation, and economic growth problems were caused or exacerbated by governmental policies based on the aggregate demand approach. First, in Keynesian theory, unemployment is almost exclusively a problem of aggregate demand.<sup>97</sup> In assuming that budget deficits stimulate aggregate demand and alleviate unemployment, the effects of wage incentives on unemployment are ignored. There is an implicit assumption that the demand for labor is

perfectly inelastic—that employers will hire the same number of workers regardless of whether the prevailing wage rate is \$2.00 per hour or \$3.35 per hour. In reality, of course, labor is similar to other goods and services in the sense that the quantity of labor demanded is inversely related to price so that the higher the wage rate the smaller the amount of labor employed. Thus, the focus on aggregate demand has detracted attention from the economic incentives which motivate decisions by individual workers and employers. A closely related implication of Keynesian theory is that a dollar spent by government will increase aggregate demand, employment, and output more than an equivalent reduction in taxes since individuals are assumed to save some of any reduction in taxes and savings increase idle cash balances.<sup>98</sup> The supply-side approach, on the other hand, stresses that a decrease in tax rates will increase incentives and bring about an increase in employment and output.

Second, Keynesian policy prescribes a government deficit during years of slack economic activity. Consequently, after the Keynesian revolution in economic policy, budget deficits were no longer taken to be a sign of irresponsible government action.<sup>99</sup> Moreover, in the aggregate demand approach, government debt is considered to be unimportant when held internally within the country since interest payments to holders of government debt are "merely transfers" and, consequently, "we owe it to ourselves." Thus, in this view of government debt it is implicitly assumed that incentives and distribution questions are unimportant. Since an increase in government debt means an increase in taxes, however, an increase in debt affects the individual taxpayer in two ways. First, higher tax rates adversely affect incentives and output. Thus, the higher the tax rates, the greater the work disincentive and the greater the incentive to avoid and evade taxes. Second, since all taxation involves coercion, the higher the debt, the more coercion involved in financing the debt.

In the aggregate demand approach, the

federal budget should be balanced over the business cycle, running a deficit during periods of economic slack and a surplus during boom periods. This "fine tuning" approach has been characterized as the "genie" conception of government.<sup>40</sup> It assumes that government will always want to, know how to, and be able to act in the "public interest." However, economic policies are instituted by politicians rather than "economic eunuchs" who "act solely to maximize social efficiency without regard to their own utility, power, prestige, income or vote appeal."<sup>41</sup> In reality, the government, not being omniscient, is faced with uncertainty and information problems. Moreover, there are important lags—between the beginning of a problem and its awareness, between awareness and action taken, and between action taken and the result of that action. Furthermore, government decision-making in reality, is fragmented and short-run oriented where the "long run" is the next election. Spending by politicians is popular while taxation is unpopular so that a politician can often strengthen his electoral support by increasing expenditures and reducing taxes.<sup>42</sup> Thus, budget deficits and surpluses are asymmetrical and there is a strong bias toward deficit spending. In practice, money creation and inflation becomes a way of financing deficits. Moreover, inflation and a "progressive tax system" also means that tax rates increase (through "bracket creep") without formal action being taken by legislators.

Third, it has become increasingly recognized that the Phillip's Curve is not an accurate representation of reality.<sup>43</sup> The Phillip's Curve purports to show that there is a trade-off between inflation and unemployment. Since inflation is always a monetary phenomenon, however, there can be no permanent trade-off between inflation and employment as once hypothesized. Instead, it is more likely that today's unemployment is the result of yesterday's inflation.<sup>44</sup> The Phillip's Curve also implies that higher employment and economic growth can be achieved by deliberately causing inflation. The

simultaneous occurrence of high inflation, high unemployment, and low productivity in the U.S. in recent years, however, has done much to disabuse people of the once commonly accepted idea that employment and productivity problems can be attributed to a lack of aggregate demand.

Finally, and closely related, there is increasing dissatisfaction with economic forecasts based on macroeconomic models. Most forecasting models (like Keynesian economics) focus on aggregate demand and are based on nationwide statistical aggregates such as national income, GNP, investment, and savings and ignore the incentive effects associated with reductions in tax rates and government spending. Incentives and expectations are not easily modelled and macroeconomic averages and aggregates often conceal causal relationships.<sup>45</sup> Keynesian forecasting models, for example, assume that a decrease in taxes will stimulate demand for goods faster than it generates output and will result in inflation. Whether or not this is the case is, of course, a moot point. Further, Keynesian models used by the Congressional Budget Office and the Office of Management and Budget in the Carter Administration predicted that investment and GNP will *fall* if corporate tax rates are decreased.<sup>46</sup> It was only in 1980 and 1981 that economic modellers began to take seriously the supply-side incentive effects of cuts in taxes and government spending. There is still no consensus as to how important these effects are. In early 1981, the forecasting models, based on aggregate demand depicted a less rosy scenario in terms of future budget deficits and inflation relative to Reagan Administration supply-side forecasters.<sup>47</sup> However, the fact that forecasting is necessarily judgmental is becoming more widely recognized. And, although business still spends large sums for economic forecasting services, there is an emerging consensus that econometric modellers have oversold their ability to predict economic conditions.<sup>48</sup>

#### *Conclusions and Implications*

IN MANY RESPECTS, CURRENT ECONOMIC CON-

ditions of the U.S. are similar to those of the mercantilist era which Adam Smith and the classical economists were reacting against—*viz*, high and increasing tax rates, increasing government regulation and intervention, low rates of productivity and growth, and a growing underground economy.<sup>49</sup> There is a growing consensus that economic incentives and entrepreneurship are not readily quantified or handled in macro forecasting models, and that the tax system should place increased priority on incentives and long run growth and less emphasis on short run stabilization and distribution.

Oxford University economist Colin Clark in the 1940's predicted that a tax burden in excess of 25 percent in peacetime would greatly discourage saving and work. Today, 70 percent of taxable income in the U.S. encounters tax rates of 25 percent or higher, and there can be little doubt about the unfavorable climate for saving.<sup>50</sup> Income is taxed when earned and interest and dividends from savings are taxed. In the case of interest or dividend income, the marginal tax rate currently is often *greater than 100 percent*. If a taxpayer in the 30 percent tax bracket, for example, invests \$100 for one year at 10 percent while the inflation rate is 12 percent, the taxpayer loses about 5 percent in purchasing power during the year. That is, after paying \$3 in taxes on the \$10 interest income, the remaining money will purchase about 5 percent fewer goods and services than the money invested one year earlier would have purchased at that time. Thus, it is not surprising that many people have decided that saving is counterproductive under current economic conditions.

There is little doubt that current tax and spending policies of the federal government discourage productive efforts. An increase of transfer payments encourages leisure just as an increase in tax rates discourages entrepreneurial creativity and productive efforts by tax payers. The higher tax rates are, the greater the incentive effects of reducing taxes. Thus, the egalitarian redistributionist mentality is central to current productivity problems.

Since most savings are by individuals in higher tax brackets, tax cuts for taxpayers in upper income tax brackets, will provide the greatest effect on savings and capital formation. Moreover, there is considerable evidence that our progressive tax system is counterproductive both in terms of production and tax revenues.<sup>51</sup> There is then a paradox of a progressive tax system—above some level, lower tax rates yield more tax revenue. Yet, a decrease in tax rates which reduces the progressivity of the tax system is counter to egalitarian views.

The stress on the importance of economic incentives is rooted in the classical principles of public finance. The supply-side approach in this sense represents a return to economy orthodoxy which was eclipsed for a generation by Keynesian doctrines and, in this context, is radical only in terms of the reigning Keynesian orthodoxy. However, to the extent that the importance of government spending is discounted, the supply-side approach is not consistent with classical principles of political economy. First, it is essential to consider political as well as economic incentives. In the view of some supply-side enthusiasts a decrease in tax rates will bring about an increase in output, an increase in tax revenues, and permit an increase in government spending without increasing budget deficits.<sup>52</sup> This approach ignores or downplays the emphasis by Adam Smith and other classical economists that public expenditures should be held to a "necessary minimum."

Moreover, when political considerations are taken into account, it becomes clear that reducing the disincentive effects of high taxes will not solve current economic problems associated with the "special interest" state. Since the benefits of various government programs are highly concentrated while the costs are widely diffused, pressures to expand government spending are great even though specific programs may benefit relatively small numbers of individuals. The benefits of the sugar price support program, for example, which results in domestic sugar prices being more

than twice the world market price, are very important to the 15,000 sugar producers in the United States.<sup>53</sup> Yet, our expenditures on sugar as individual consumers are low enough that it is not in our economic interest as individuals to devote much time to sugar legislation. When the bias in favor of government spending is recognized, it becomes clear that the only way to control government expenditures is to deny politicians the money in the first place. Thus, tax revenues cannot be considered independently of government spending. Rephrasing Parkinson's Law, "Government expenditures always expand to exceed government revenues in the special interest state."

Second, both supply side and Keynesian fiscal policy provide good news to political entrepreneurs.<sup>54</sup> As suggested earlier, Keynesian theory suggests that spending will lead to economic growth and that government should run a deficit in periods of economic slack. However, borrowing or money creation to finance a deficit weakens the responsibility of legislators for their budgetary decisions.<sup>55</sup> A severing of the link between government expenditures and the taxes necessary to finance the expenditures has been welcome news to politicians who find it more popular to spend than to levy taxes. Similarly, in suggesting that a decrease in tax rates will increase tax revenues, Gilder, Laffer, and Wanniski also provide welcome news to politicians. Interpreted in this way, a reduction in tax rates will permit continuation of Great Society, New Deal, and other welfare state programs *and* at the same time reduce budget deficits and inflation. Supply-side economics defined in classical terms, however, also requires a reduction in government intervention and spending. Thus, Laffer's claim that with tax cuts the government would not have to cut spending is beside the point. Tax cuts and budget cuts make sense irrespective of whether a decrease in tax rates increases tax revenues.<sup>56</sup>

Third, there is an assumption on the part of some supply-side economists (as well as some monetarists) that inflation can

be solved easily and painlessly: "At this juncture, there is no practicable anti inflation program except Lafferite economics...."<sup>57</sup> Most economists agree that a reduction in the rate of growth in the money supply will be required to reduce the rate of inflation. However, there is no consensus on the nature of the adjustment process. Irving Kristol, for example, holds that reductions in tax rates, government spending, and in the rate of growth of the money supply can reduce inflation without serious disruption in economic activity.<sup>58</sup> A similar view is shared by many monetarists. This view is at variance with that of the neo-Austrians. Hayek, for example, contends that a little inflation always generates higher inflation and that there is no way to cure a serious inflation without a steep recession.<sup>59</sup> While Gilder, Kemp, Kristol, Laffer, and other supply-siders contend that the budget can be balanced through a renewal of economic growth achieved by tax cuts, Hayek holds that government spending must be reduced to reduce budget deficits. The Reagan Administration contended in 1981 that the proposed 30 percent cut in income tax rates over three years would increase incentives sufficiently so that tax revenues would increase. However, the Reagan Administration's proposals are consistent with those of the classical economists in also emphasizing reductions in government spending and government regulation.

Fourth, it should be recognized that all statistical economic relationships are historical in nature and that any particular relationship is unique to time and place. The effect of a tax cut on savings, investment, output, and tax revenues, for example, will likely vary between countries and over time within a given country for various reasons including cultural factors, level of current tax rates, expectations regarding inflation, and the investment climate. Relationships among economic variables as well as people's reactions to economic, political, and social developments change over time in unpredictable ways. In short, there are no constants in human behavior.<sup>60</sup> Thus, past relation-

ships cannot be assumed to provide a good prediction of future events, and the conclusion as to whether a reduction in tax rates will increase tax revenues is a matter of inference and judgment.<sup>61</sup>

Finally, in evaluating the merits of various government remedies to cope with inflation, productivity, and employment problems, it is important to take a principles approach rather than one of case-by-case opportunism.<sup>62</sup> The principles approach recognizes that the task of a policy maker is *not* to "fine tune" fiscal policy or to maximize social welfare somehow conceived. It is concerned instead with the framework of institutions and rules within which people can effectively cooperate in pursuing their own diverse ends through decentralized coordination of their activities. In this focus on constitutional issues, it is recognized that economic policies cannot be considered independently of the political process. When the imperfections of the political process are taken into account, there is no convincing evidence that government has been or can be effective in stabilizing economic activity.<sup>63</sup> In a return to basic principles, the in-

dividual must occupy the center of the economic universe. Moreover, it should be emphasized that market interactions are subtle, that the feedbacks are complex, and that econometric models cannot satisfactorily simulate the interactions and feedbacks of real world markets. Thus, it is important to recognize both that monetary and fiscal policies cannot be "fine tuned" on the basis of such models and that decisions to reduce government spending should not hinge on projected changes in revenues from reductions in tax rates. Instead, reductions in taxing, spending and government regulations must all be emphasized in a return to basic principles. Government transfer payments are difficult to stop because of concentrated benefits and diffuse costs, and it is likely that effective constraints on government spending must take the form of constitutional restraints.<sup>64</sup> In conclusion, supply-side economics properly defined is an important facet of a principles approach that "would go far...toward reinstating the wisdom of the Founding Fathers regarding the scope and power of government."<sup>65</sup>

<sup>1</sup>"Remember, the reason for the tax cuts is to cause real output to grow faster than government spending." Paul Craig Roberts, "Supply-Side Economics: A Fiscal Revolution," *Wall Street Journal*, January 22, 1981; "The purpose of the cuts, it must be continually stressed, is to expand the tax base—to make the rich pay more taxes by inducing them to consume less and to work and invest more." George Gilder, *Wealth and Poverty* (New York: Basic Books, 1981).

<sup>2</sup>Robert E. Keleher and W.P. Orzechowski, *Supply-Side Effects of Fiscal Policy: Some Historical Perspectives*, Working Paper Series (Atlanta: Federal Reserve Bank of Atlanta, 1980).

<sup>3</sup>Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: Random House, 1937), p. 835.

<sup>4</sup>Jude Wanniski, *The Way the World Works* (New York: Simon and Schuster, 1978); Gilder, *op. cit.*; Works by Bethel, Laffer, Kristol and Roberts are cited below.

<sup>5</sup>John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace and Company, 1958).

<sup>6</sup>James D. Gwartney and Richard Stroup, *Economics: Private and Public Choice*, Second ed. (New York: Academic Press, 1980), p. 280.

<sup>7</sup>Several of the examples cited below are from Gwartney and Stroup, *op. cit.*, pp. 276-278.

<sup>8</sup>Carl F. Christ and Alan A. Walters, "The Mythology of Tax Cuts," *Policy Review*, 16 Spring 1981, pp. 73-86.

<sup>9</sup>Cited in Arthur Shenfield, *The Failure of Socialism: Learning from the Swedes and English* (Washington: The Heritage Foundation, 1980), p. 16.

<sup>10</sup>Antonio Martino, "Measuring Italy's Underground Economy," *Policy Review*, 16 Spring 1981, pp. 87-106.

<sup>11</sup>Edgar L. Feige, "How Big is the Irregular Economy?" *Challenge*, Nov.-Dec. 1979, pp. 5-13.

<sup>12</sup>Robert E. Keleher, *Supply-Side Effects of Fiscal Policy: Some Preliminary Hypotheses*, Research Paper No. 9 (Atlanta: Federal Reserve Bank of Atlanta, 1979).<sup>13</sup>*Ibid*, p. 19.<sup>14</sup>Wanniski, *op. cit.*, p. 97.

<sup>15</sup>Philip F. Lawler, "The Reagan Tax Cuts: Soaking the Rich," Press release, The Heritage Foundation, March 18, 1981; Gilder, *op. cit.*, p. 188.

<sup>16</sup>Arthur Laffer Interview, *Reason*, April 1981, pp. 44-50. Wanniski, *op. cit.*, p. 98.

<sup>17</sup>There is widespread disagreement on this issue. After analyzing the effects of tax rates and productivity between countries and the effects of changes in tax rates over time, for example, Christ and Walters con-

clude "that tax cuts in the U.S. will reduce tax revenue, not increase it, even though output may rise." Carl F. Christ and A.A. Walters, *op. cit.*, p. 86.

<sup>18</sup>Keleher and Orzechowski, *op. cit.*, p. 43.

<sup>19</sup>Michael K. Evans, "Taxes, Inflation and the Rich," *Wall Street Journal*, March 7, 1978. <sup>20</sup>*Ibid.*

<sup>21</sup>John Mueller, "Lessons of the Tax-Cuts of Yesteryear," *Wall Street Journal*, March 5, 1981.

<sup>22</sup>Gwartney and Stroup, *op. cit.*, p. 280.

<sup>23</sup>Mueller, *op. cit.*

<sup>24</sup>Alan Reynolds, "What Do We Know About the Great Crash?" *National Review*, Nov. 9, 1979.

<sup>25</sup>Keleher and Orzechowski, *op. cit.*, p. 57.

<sup>26</sup>Allan H. Meltzer, "Keynes General Theory: A Different Perspective," *Journal of Economic Literature*, 19 (1), March 1981, p. 61. <sup>27</sup>*Ibid.*

<sup>28</sup>Keleher and Orzechowski, *op. cit.*, p. 58.

<sup>29</sup>Paul A. Samuelson, *Economics*, Eleventh ed. (New York: McGraw-Hill Book Co., 1980), pp. 225-227. <sup>30</sup>Reynolds, *op. cit.*, p. 1420. <sup>31</sup>*Ibid.*

<sup>32</sup>Benjamin M. Anderson, *Economics and the Public Welfare* (Indianapolis: Liberty Press, 1979).

<sup>33</sup>Reynolds, *op. cit.* <sup>34</sup>Anderson, *op. cit.* p. 365.

<sup>35</sup>Reynolds, *op. cit.*

<sup>36</sup>Tom Bethel, "The Death of Keynes: Supply-Side Economics," *National Review*, December 31, 1980.

<sup>37</sup>James Gwartney and Richard Stroup, "The Creation of Economic Chaos: Inflation, Unemployment, and the Keynesian Revolution," *The Intercollegiate Review*, Fall/Winter, 1980, pp. 3-9.

<sup>38</sup>Tom Bethel, "Reagan's Economic Package: It's Not Good Enough," *National Review*, April 3, 1981.

<sup>39</sup>Richard E. Wagner and Robert D. Tollison, *Balanced Budgets, Fiscal Responsibility and the Constitution* (San Francisco: Cato Institute, 1980).

<sup>40</sup>Paul Heyne, *The Economic Way of Thinking*, Third ed. (Chicago, SRA, Inc., 1980).

<sup>41</sup>Steven, N.S. Cheung, *The Myth of Social Cost*, Hobart Paper 82 (London: Institute of Economic Affairs, 1978), p. 81. <sup>42</sup>Wagner and Tollison, *op. cit.*, p. 7. <sup>43</sup>Heyne, *op. cit.*

<sup>44</sup>F.A. Hayek, *Prices and Production*, Second ed. (New York: Augustus M. Kelley, 1935 ed., reprinted 1967).

<sup>45</sup>Bethel, 1980, *op. cit.* See also: "Where the Big

Econometric Models Go Wrong," *Business Week*, March, 30, 1981.

<sup>46</sup>Paul Craig Roberts, "Caricatures of Tax-Cutting," *Wall Street Journal*, April 24, 1980.

<sup>47</sup>"Forecasting Flap: Who is Right?" *Wall Street Journal*, March 23, 1981.

<sup>48</sup>"Where the Big Econometric Models Go Wrong," *Business Week*, March 30, 1981.

<sup>49</sup>Keleher and Orzechowski, *op. cit.*, p. 66.

<sup>50</sup>Paul Craig Roberts, "Avoiding an Economic Dunkirk," *Wall Street Journal*, December 18, 1980.

<sup>51</sup>Michael E. Evans, "The Source of Personal Saving in the U.S.," *Wall Street Journal*, March 23, 1981; Alvin Rabushka, "The Attractions of a Flat-Rate Tax System," *Wall Street Journal*, March 25, 1981.

<sup>52</sup>Laffer Interview, *op. cit.*

<sup>53</sup>E.C. Pasour, Jr., "A Critique of Federal Agricultural Programs," *Southern Journal of Agricultural Economics*, Vol. 12(1), July 1980, pp. 29-37.

<sup>54</sup>Gwartney and Stroup, *op. cit.* <sup>55</sup>Wagner and Tollison, *op. cit.*, p. 23.

<sup>56</sup>David Henderson, "Limitations of the Laffer Curve as a Justification for Tax Cuts," *The Cato Journal*, 1(1), Spring 1981, pp. 45-52.

<sup>57</sup>Gilder, *op. cit.*, p. 205.

<sup>58</sup>Irving Kristol, "A Guide to Political Economy," *Wall Street Journal*, December 19, 1980.

<sup>59</sup>F.A. Hayek Interview, "Recession as Inflation's Only Cure," *Business Week*, December 15, 1980.

<sup>60</sup>Ludwig von Mises, *Human Action*, (Chicago: Henry Regnery Co., 1966).

<sup>61</sup>Arthur B. Laffer, "Government Exactions and Review Deficiencies," *The Cato Journal*, 1(1), Spring 1980, p. 12.

<sup>62</sup>Leland B. Yeager, "Economics and Principles," *Southern Economic Journal*, 42(4), April 1976, pp. 559-571.

<sup>63</sup>James M. Buchanan, *et. al.*, *The Economics of Politics*, IEA Readings 18 (London: The Institute of Economic Affairs, 1978).

<sup>64</sup>Terry L. Anderson and Peter J. Hill, *The Birth of a Transfer Society*, (Stanford, CA: Hoover Institution Press, 1980).

<sup>65</sup>Yeager, *op. cit.*, p. 570.