

BOOK REVIEWS

The Supply-Side Solution

Edited by Bruce Bartlett and Timothy P. Roth
Chatham, N.J.: Chatham House Publishers for
the Manhattan Institute, 1983. 289 pp.

As accepted economic theory, orthodox Keynesian economics is dead. It has been executed by experience. But though its life as a reputable economic theory is over, Keynesian economics still lives on in the form of political expediency. Few politicians can resist the fundamental notion of Keynesian economics—that demand, especially demand exerted through the political process, translates quickly and painlessly into production. The hope and promise of supply-side economics was that it would replace Keynesian economics on two fronts: First, by providing a solidly based theoretical alternative to Keynesianism, and second, by providing politically attractive policy recommendations. The first objective has surely been accomplished, as evidenced by the collection of articles in *The Supply-Side Solution*, edited by Bruce Bartlett and Timothy P. Roth. But the second objective has encountered serious difficulties.

The political dimension of the problem faced by supply-side economics is best appreciated once its purely economic features are examined. It is in this sense that one can usefully read *The Supply-Side Solution*. The articles in this volume focus on some important economic questions: How is supply-side economics different from Keynesian economics? What are the limitations of Keynesian economics? In what ways does movement from the Keynesian to the supply-side approach constitute improvement in theory and policy? What is the current state of the U.S. economy? What would be the effect on the tax base and tax revenues if tax rates were cut? Can supply-side economics succeed?

To establish that these questions are worth addressing, one must first dismiss the belief that supply-side economics is simply a fad that grew out of the rhetoric of the Reagan campaign. Bartlett and Roth, in their introduction, and John Tatom, in his opening article, "We Are All Supply-Siders Now," do this very effectively. They show that supply-side economics is solidly grounded in economic analysis that goes back at least 200 years to the publication of *The Wealth of Nations*. In Adam Smith's view, and in the view of economists in general until the 1930s, production

ultimately determines the wealth of a nation. It is this emphasis on production that distinguishes supply-side economics from Keynesian economics. Norman Ture emphatically points out in his article, "The Economic Effects of Tax Changes: A Neoclassical Analysis," that the purpose of a tax cut is to increase incentives to produce, not to increase disposable income and current consumption. Supply-siders are concerned with the effect of marginal tax rates on relative prices, rather than with the effect of average tax rates on disposable income.

In his article, "The Breakdown of the Keynesian Model," Paul Craig Roberts provides a devastating critique of the Keynesian approach to macroeconomic policy—an approach that ignores or downplays the incentive effects of changes in marginal tax rates. For example, it has been argued that reducing the marginal tax on labor income will have little, if any, effect on labor supply because the increased return to effort will be offset by increased income, which will prompt workers to consume more leisure. But Roberts neatly points out the fallacy of composition inherent in this argument. If one individual experiences an income tax reduction, he will be able to maintain his consumption of goods and services while increasing his leisure and producing less. However, if everyone receives an income tax cut, there will be no aggregate income effect since there will be no automatic increase in output. The income effect cannot come into effect until people respond to the tax cut by producing more. Therefore, the income effect can only moderate the incentive effect on a supply-side tax cut; it cannot completely offset it.

Michael Evans, in "The Bankruptcy of Keynesian Econometric Models," points to the hopeless inaccuracy of econometric models that attempt to reduce the economy to a series of equations based on Keynesian assumptions. He makes a convincing case that such models are naive in the extreme. But the same is true of the econometric models based on supply-side assumptions that Evans is recommending. And this is independent of the validity of the supply-side perspective. The type of information needed for the forecasting big-model builders claim to be capable of is simply too subjective and diffused to be meaningfully aggregated by any cadre of experts. The problem with all of these models is that their scientific aura beguiles bureaucrats and politicians into the pernicious belief that they can steer the economy along the appropriate path with the right mix of monetary and fiscal policies. The advantage in returning to the supply-side perspective is not in having supply-side fine-tuners replace Keynesian fine-tuners. The advantage is in gaining the understanding that in the long-run a stable and predictable incentive structure is important to economic progress, and that economic fine-tuning of any type is inimical to such an incentive structure.

Most of the articles in *The Supply-Side Solution* attempt to glean from the empirical evidence just what impact supply-side incentives will have on the economy. Michael Boskin makes a strong empirical case for a proposition that seems rather obvious, but one the Keynesians have been

ridiculing for years. The proposition is that private saving will increase in response to an increase in the after-tax rate of return. Several implications flow from this, not the least important of which deals with the likely impact of reducing the marginal tax rate on capital income. Given the saving response that Boskin found, and empirical measures on the substitutability between capital and labor, there is reason to believe that reducing the tax on capital income will transfer gross income from capital to labor.

Robert Keleher follows with an article surveying some of the empirical evidence on the likely effects of a supply-side tax cut. He argues that the estimates probably understate the positive impact of these cuts. Arthur Laffer, after developing an analytical framework for examining the economic implications of marginal tax cuts, contrasts the economic situation in the early 1960s with that of the 1970s. Drawing on this comparison, he concludes that cutting taxes along the lines suggested by President Reagan in early 1981 is a reasonable approach to balancing the budget. Laffer, however, does not mention the impact monetary policy might have on his predictions, something he would certainly do if he were revising his article today.

The next three papers apply sophisticated econometric techniques to ascertain whether or not the tax policy of particular governments may have actually moved tax rates into the prohibitive region of the Laffer curve. Using a large econometric model and a range of labor supply elasticities obtained from existing studies, Don Fullerton concludes that tax policy probably has not taken the U.S. economy into the prohibitive region of the Laffer curve. Charles Stuart, using an approach roughly similar to Fullerton's, concludes that taxes in Sweden have almost certainly moved that country into the prohibitive region. Looking at local tax policy in the city of Philadelphia, Ronald Grieson finds that Philadelphia is near, if not at, the peak of the Laffer curve.

Several other notable papers follow. These papers, broadly speaking, conclude that the productive incentives being emphasized by supply-side economists cannot be ignored without risking serious and adverse long-run consequences to economic performance. Aris Protopapadakis concludes that volume with an article entitled, "Supply-Side Economics: What Chance for Success?" In keeping with most of the previous articles, Protopapadakis concludes that supply-side tax cuts can motivate important gains in output and productivity over the long run, but are unlikely to generate much gain in the short run. This long-run, short-run distinction, a distinction mentioned by many of the authors in this volume, is crucial in answering the question that Protopapadakis asks but never answers: What chance for success?

From a strictly economic perspective, there is no question that supply-side economics recommends policy prescriptions that will be successful in the long run. But unfortunately, the real success of supply-side economics depends as much, if not more, on political considerations as on

economic considerations. And the political process is pathologically shortsighted. As the former prime minister of Great Britain, Harold Wilson, once said, "A week is a long time in politics." It is this myopic view that made Keynesian economics so politically acceptable and presents supply-side economics with its greatest challenge.

Stimulating the economy before the next election with demand-side policies is relatively easy. Real improvement in the economy's productive capacity, however, takes sacrifice, hard work, and patience—attributes that hold little appeal for the free-lunch crowd in Washington. As much as one may fault the more extreme supply-siders who argued that tax cuts would immediately generate greater productivity and more tax revenue, such free-lunch claims may have been the only way for supply-siders to get their policy program on the political agenda. The success of supply-side economic policy, however, will ultimately depend as much on constraining shortsighted political proclivities as on reestablishing productive economic incentives.

In the meantime, it is important that supply-side economics be correctly perceived as grounded in serious economic analysis and as capable of improving the long-term productive capacity of the economy. *The Supply-Side Solution* is an important contribution in this regard. It provides us with a series of articles by serious scholars who make a compelling case that supply-side economics is a viable long-run solution to our current economic problems.

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Development Without Aid

Melvin B. Krauss

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Melvyn Krauss has written a book that explores not only the policies that promote Third World development—primarily sensible domestic economic policies—but also those that do not, particularly foreign aid. Krauss' message is all the more important since Congress voted to give the International Monetary Fund (IMF) an additional \$8.4 billion in an attempt to bail out insolvent Third World debtors and their Western banking creditors. Unfortunately, *Development Without Aid* suggests that this short-term palliative may ultimately hinder Third World development.

By almost any measure, the problems besetting most of the developing world are severe: dismal economic growth rates, millions in abject poverty and near starvation, and multibillion dollar international debts. For a solution, Third World leaders have turned to international politics and wealth redistribution, devoting their energies to building an active transnational redistributionist movement—a phenomenon left unexamined by Krauss. In doing so, they have wasted valuable intellectual and eco-