POLICY REPORT

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The Case for Supply-Side Economics

by Bruce Bartlett

In many respects, supply-side economics is nothing more than classical economics rediscovered. More particularly, it is Say's Law of Markets rediscovered. The essence of Say's Law, named for the great French economist Jean Baptiste Say, is that goods are ultimately paid for with other goods. Thus it is production that limits the satisfaction of human wants, not the ability to consume, which, in the aggregate, is unlimited. Consequently, Say argued that "the encouragement of mere consumption is no benefit to commerce; for the difficulty lies in supplying the means, not in stimulating the desire of consumption; and we have seen that production alone furnishes those means. Thus it is the aim of good government to stimulate production, of bad government to encourage consumption."[1]

This doctrine was essentially accepted by all economists until the Great Depression, when it came under heavy attack from John Maynard Keynes, who misunderstood and misrepresented the basis of Say's Law. He turned Say's Law into a simple statement that "supply creates its own demand" and said that this is "equivalent to the proposition that there is no obstacle to full employment." In defense of this proposition Keynes quoted John Stuart Mill out of context, implying that Say's Law holds that there can never be an oversupply of any product, when in fact Mill states only that there cannot be a general oversupply of all goods.[2]

Keynes argued that the cause of the Great Depression was underconsumption and that government policy ought to be directed toward stimulating demand by means of budget deficits and easy money. Keynes's theory soon became the new economic orthodoxy, largely because his policy prescriptions coincided with the politics of the times. As Joseph Schumpeter said of Keynes's *General Theory,* "Whatever its merit as a piece of analysis may be, there cannot be any doubt that it owed its victorious career primarily to the fact that its argument implemented some of the strongest political preferences of a large number of modern economists."[3]

"The heavily Keynesian economic policies of the 1960s and 1970s were sowing the seeds of their own destruction."

In fact, there *was* a serious problem with the demand side of the economy in the 1930s, but it had nothing to do with Keynesian theory. The problem resulted from the Federal Reserve Board's tragic blunder in causing the U.S. money stock to decline by over a third between 1929 and 1932. When the rigidities of the economy prevented prices and wages from falling to an equilibrium level consistent with the existing money stock, the depression ensued.[4] The great error of economists and policy makers was accepting Keynesian demand-management theories as the basis for a general economic program, rather than restricting them to the conditions of a deflationary depression.

By the end of World War II Keynesian economics had the nearly total allegiance of younger economists. By the 1960s they were the full professors at most universities, their influence so pervasive that Milton Friedman, the preeminent monetarist, remarked in 1965, "We are all Keynesians now."[5] But the heavily Keynesian economic policies of the 1960s and 1970s were sowing the seeds of their own destruction.

In a real sense, Keynesian economics died during the recession of 1974–75. In 1975 the unemployment rate hit its highest level since the depression—8.5%—despite a $45 billion budget deficit, the largest since World War II until that time, and a soaring inflation rate. According to conventional Keynesian theory, this just couldn't happen. The Phillips curve, a basic Keynesian component, shows that there is an inverse relationship between inflation and unemployment—the higher one is the lower the other should be—and thus the Keynesians were completely baffled about what policy prescription to

(Cont. on p. 3)

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EDITORIAL

FDA: Protection or Plague?

The Food and Drug Administration continues to cause needless deaths and suffering because of its regulation of the drug industry. It has been charged that the ultimate responsibility for the majority of the deaths of children with SSPE, a form of encephalitis (brain measles), lies on the shoulders of the federal government, particularly the Food and Drug Administration. Despite nine years of testing and active use in 35 nations around the world, including England, France, and West Germany, the FDA has refused to allow the marketing of isoprinosine, which is effective in arresting the fatal effects of SSPE in 75% of the cases. This refusal continues despite a recent statement by a medical advisory group that isoprinosine could save up to 80% of the victims of encephalitis.

The FDA's ban on the use of isoprinosine was enacted because there have been no "controlled" studies. One of the FDA's regulations for new drugs requires a blind study using two groups, one of which, the "control" group, receives a placebo and the other of which receives the actual drug being tested. In order not to bias the results, the "control" group is told that they are receiving the actual drug when in fact they are receiving a sugar pill. Both the manufacturer and medical groups from Yale University and Massachusetts General Hospital have refused to participate in such a study on ethical and moral grounds. Because both the manufacturer and the medical groups believe the drug is effective, their participation would require them to give dying children a sugar pill instead of saving their lives. The FDA, supposedly formed to monitor ethics in the private sector, could conceivably be charged with demanding unethical testing methods in order to fulfill its regulatory function.

Other FDA victims include potential users of alprenolol, a heart-attack drug that has been available in Sweden since 1967, and practolol, which is capable of saving 10,000 to 20,000 lives a year. The FDA has kept other heart-related drugs off the market for eleven years, despite their widespread use in Great Britain. Other victims include people suffering from ulcers, gallstone, epilepsy, depression, and migraine. One drug, cyanoacrylate, has been tested for over 25 years, and was used extensively during the Vietnam War on American soldiers. It has saved many seriously ill patients from massive hemorrhaging, yet it is still banned.

The FDA's stringent testing requirements have delayed new drugs from coming on the market by an average of 7 to 10 years, and in some cases, up to 20 years. Since the additional efficacy standards were set in the early 1960s, the number of new drugs coming on the market has been reduced by approximately 50%, and the costs of marketing these new drugs have increased by $60 million.

The secondary consequences of such regulations are quite apparent. The incentive to invest for a period of 10 years without knowing whether the outcome will meet bureaucratic approval, let alone pass the test of the market, is not likely to encourage research and development activity. The research and development that does take place will generally be by larger firms who can afford the tremendous investment and be able to spread the cost of the risk over a number of ventures. The costly testing procedures affect not only the number of new drugs, they also affect the type of new drugs. Firms that do try to develop and market new drugs will target existing markets, such as aspirin substitutes, and will avoid innovation in new areas. Medicines for diseases that affect only small segments of the population are made unprofitable by FDA regulations.

The effect of the FDA is to hurt the poor, the elderly, and the disabled, those groups who most often suffer the burdens of government regulation. Low- and middle-income people can rarely afford to travel abroad to be treated with the drugs banned in the United States. Those low-income individuals who do travel generally settle for lower quality medical care in other countries.

Representative Elizabeth Holtzman has introduced a bill, H.R. 7089, to establish an agency to assist in the development of unprofitable drugs. H.R. 7089 is a typical political solution to a problem caused by one government agency: establish another agency. There is no doubt that when this new office causes other problems we will have a call for yet another agency—all at the taxpayers' expense.

Regardless of whether saccharin causes cancer in rats, or whether Laetrile, although safe, may encourage people to forgo the devastating standard cancer cures; regardless of whether diet bread has 30% or 40% fewer calories than regular bread (a new FDA concern) or whether peanut butter has been found dangerous, the fundamental question comes down to the ethical principle of individual rights. Do *we* have the right to protect ourselves or does the state have this right? Last October Jere Goyan, the new head of the FDA, announced that "my general philosophy is the fewer drugs people take, the better off they are." If Mr. Goyan wants to take fewer drugs, that's his own business, but some of us may want our children with encephalitis to have every possible chance and terminally ill cancer patients to take whatever drugs they need to survive. If the FDA doesn't think a particular drug is effective, we recommend that they don't take it. We would like to make our own decision. If we all could make our own decisions thousands of people might still be alive. ■

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offer.[6] Normally, unemployment calls for a budget deficit, and inflation calls for a budget surplus. In the face of the largest peacetime deficit in American history and double-digit inflation, Keynesians could hardly call for more deficit spending, but a reduction in the deficit to battle inflation would worsen the already bad unemployment situation. The Keynesians were therefore left with no solution to offer. Many began to proclaim the death of Keynes.[7]

The question thus arose, What will take the place of Keynesian economics? Irving Kristol was the first to draw attention to supply-side economics as a replacement for the discredited Keynesian school:

> In response to this crisis in the theory of economic policy, a "new" economics is beginning to emerge.... Its focus is on economic growth, rather than on economic equilibrium or disequilibrium, and it sees such growth arising from a free response (e.g., investment, hard work, etc.) to the economic incentives of a free market.
>
> It does retain the Keynesian macroeconomic apparatus for diagnostic purposes, but its inclination is "conservative" rather than "liberal"—i.e., it believes that only the private sector can bring us sustained economic growth, and that whatever tasks one might wish to assign to the public sector, economic growth cannot be one of them.
>
> This "new" economics is sometimes described, rather cumbersomely, as "supply-side fiscal policy."...It arises in opposition to the Keynesian notion that an increase in demand, by itself, will increase supply and therefore accelerate economic growth. The "new" economics asserts that an increase in demand, where the natural incentives to economic growth are stifled, will result simply in inflation. It is only an increase in *productivity*, which converts latent into actual demand by bringing commodities (old and new) to market at prices people can afford, that generates economic growth.[8]

"The supply-side economists argue that tax cuts should be structured to give the maximum stimulus to investment, savings, and work incentive."

The difference between the supply-side economists and the Keynesians is most graphically shown by their attitude toward taxation. To the Keynesians, rising taxes hurt the economy only because they cut down on consumer purchasing power. Conversely, to the Keynesians, all tax cuts are the same. It makes little difference whether you have a tax rebate, a tax cut only for those with low incomes, a tax cut only for those with high incomes, a corporate tax cut, whether you cut average tax rates or marginal tax rates, or whether you cut taxes for individuals or businesses. No matter how you do it only one thing counts: the aggregate size of the tax cut, for this alone determines how much fiscal stimulus there will be to aggregate demand.[9] Consequently, it makes no difference to the Keynesians whether you cut taxes or increase government spending since either method generates the same result.

By contrast, to the "new" economists, the supply-side fiscalists, it makes all the difference in the world whether you cut taxes or increase spending, and there are vast differences between the effects of various kinds of tax cuts. They would say that tax rebates and increases in spending stimulate inflation and do nothing for supply because they must be financed either through borrowing—which crowds out private borrowers and raises interest rates—or by increasing the quantity of money through monetization of the debt.[10]

The supply-side economists argue that tax cuts should be structured to give the maximum stimulus to investment, savings, and work incentive. This means a preference for marginal tax rate reductions because they increase the trade-off between work and leisure, investment and consumption. Similarly, they favor reductions in the corporate tax rate, which affect the rate of return, rather than investment tax credits, which primarily affect cash flow.[11]

The principal issue is whether or not a tax cut per se is inflationary and whether a tax cut must be accompanied by a dollar-for-dollar cut in government spending to be effective. Those who argue against tax cuts because they are inflationary or who demand matching spending cuts are not true supply-siders but really conservative Keynesians, for it is only in the Keynesian model that tax cuts are assumed to stimulate demand and there-

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fore inflation. In the supply-side model the critical question is how taxes are being cut. A tax cut that merely reduces government revenue, while government spending remains the same, might be inflationary because it would probably require monetization of the increased debt. But a reduction in tax rates—in particular, marginal tax rates—does more than just increase individual disposable incomes: It alters relative prices, changing the trade-off between work and leisure, savings and consumption. Whether such a tax cut would be inflationary in the short run will depend on how much additional production and saving it generates and on how the government finances its short-run deficit.

Even some self-professed supply-siders fail to see this difference and oppose any tax cut without a corresponding spending reduction. Martin Feldstein, for example, recently said, "Although I support a supply-side approach to unemployment and productivity, I am convinced that inflation will be tamed only by appropriate limits to demand."[12] Dr. Michael Evans, who built a supply-side econometric model for the Senate Finance Committee, has made much the same point, saying the Roth-Kemp 30% tax rate reduction would be highly inflationary.[13] And the Federal Reserve Bank of Minneapolis has argued that because the real burden of government is what it spends, a tax cut merely shifts government finances from taxes to borrowing. Insofar as the increased deficit is inflationary it may actually increase the tax burden in the long run by pushing people up into higher tax brackets.[14]

Unfortunately, all of this criticism misses the point, which is that cutting tax rates does much more than reduce government revenue. It eliminates disincentives. As Paul Craig Roberts recently argued,

> The total resources claimed by government *is* a better measure of the tax burden than tax revenues alone. But some economists let this adding up of concrete resources blind them to another measure of the real tax burden—*the production that is lost to disincentives*. It is difficult to see the production that doesn't take place because the government has made it unprofitable, but is nevertheless a part of the tax burden.
>
> From the viewpoint of this more complete measure of the tax burden, a tax cut can be real even if it is not matched dollar for dollar with a spending cut. That's because a reduction in marginal tax rates changes relative prices. It causes people to shift into work out of leisure and into investment out of current consumption. These shifts occur even if people expect that in the future taxes might be raised to pay off any government debt incurred by cutting tax rates. In the meantime, however, the additional work and investment expands the tax base; to make good on the deficit, future tax rates would not have to be raised as much as they were cut—if they need to be raised at all.[15]

The theoretical support for Roberts's argument can be found in the work of Sir John Hicks, among others. In *Value and Capital* Hicks pointed out that price changes involve income and substitution effects. Thus a fall in the price of a commodity makes the consumer better off by raising his real income in terms of goods. On the other hand, it changes relative prices, causing a substitution effect in which the consumer will substitute the commodity whose price has fallen for other commodities. Since the buyer's income gain is exactly offset by the seller's loss, the income effects are canceled, leaving the substitution effect.[16]

So too with changes in tax rates. A reduction in tax rates may reduce the government's revenue, requiring it to borrow more from the public,but the income gain of the taxpayer whose rate is cut is exactly offset by another whose savings went into government debt instead of being consumed or invested in some other way. Thus the income effects cancel out, leaving the substitution effect. (If the government had inflated the currency instead of borrowing the money it would be the same thing, the currency expansion being seen as forced saving or a tax on cash balances.) The substitution effect will cause people to substitute work for leisure and saving for consumption.

Another line of argument is that because inflation is fundamentally caused by an increase in the quantity of money in excess of the growth of goods and services, any tax cut that causes more goods and services to be produced will be antiinflationary as long as the money supply is tightly controlled. This is essentially the view of the Joint Economic Committee, which has published two papers showing how tax cuts can reduce inflation.[17] Conversely, there is now growing doubt that the traditional Keynesian cure for inflation—a recession—will work because it leads to a decline in the production of goods and services while the money stock remains unchanged.[18]

In the end, the political process will decide whether an antiinflationary tax cut is possible. The fact is that the Congress just does not like the Keynesian cure for inflation—unemployment, declining economic growth, etc. Despite opposition to a supply-side tax cut, the political appeal is enormous; it promises that inflation can be reduced without running the country through a wringer and allows politicians to give the people tax cuts without fearing additional inflation.[19] If such a tax cut is enacted and works, supply-side economics may suddenly find itself as the new economic orthodoxy for a generation. ■

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[1]Jean Baptiste Say, *A Treatise on Political Economy* (1832), reprinted in Henry Hazlitt, ed., *The Critics of Keynesian Economics* (Princeton, NJ: Van Nostrand, 1960), pp. 20–21. On the history of Say's Law, see Thomas Sowell, *Say's Law: An Historical Analysis* (Princeton, NJ: Princeton University Press, 1972).

[2]John Maynard Keynes, *The General Theory of Employment Interest and Money* (New York: Harcourt, Brace & Co., 1936), pp. 18, 26; Benjamin M. Anderson, *Economics and The Public Interest* (Princeton, NJ: Van Nostrand, 1949), pp. 390–93; W.H. Hutt, *A Rehabilitation of Say's Law* (Athens, OH: Ohio University Press, 1974), pp. 24–29.

[3]Joseph Schumpeter, *History of Economic Analysis* (New York: Oxford University Press, 1954), p. 1121n; see also Bruce Bartlett, *The Keynesian Revolution Revisited* (Greenwich, CN: Committee for Monetary Research and Education, Monetary Tract No. 20, October 1977).

[4]Milton Friedman and Anna Schwartz: *A Monetary History of the United States, 1867–1960* (Princeton, NJ: Princeton University Press, 1963), pp. 209–419.

[5]Similarly, President Richard Nixon said in 1971, "I am now a Keynesian."

[6]A. W. Phillips, "The Relationship Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861–1957," *Economica* (November 1958), pp. 283–99.

[7]Editorial, "Keynes Is Dead," *Wall Street Journal* (January 31, 1977); "Is Keynes Dead?" *Newsweek* (June 20, 1977), pp. 74–75.

[8]Irving Kristol, "Toward a 'New' Economics?" *Wall Street Journal* (May 9, 1977).

[9]Paul Craig Roberts, "The Breakdown of the Keynesian Model," *The Public Interest* (Summer 1978), pp. 20–33.

[10]See Keith M. Carlson and Roger W. Spencer, "Crowding Out and Its Critics," *Federal Reserve Bank of St. Louis Review* (December 1975), pp. 2–17; Charlotte E. Ruebling, "Financing Government Through Monetary Expansion and Inflation," *Federal Reserve Bank of St. Louis Review* (February 1975), pp. 15–23.

[11]See Arthur B. Laffer, "An Equilibrium Rational Macroeconomic Framework," in Nake M. Kamrany and Richard H. Day, eds., *Economic Issues of the Eighties* (Baltimore, MD: The Johns Hopkins University Press, 1979), pp. 44–57; Paul Craig Roberts, "The Economic Case for Kemp-Roth," *Wall Street Journal* (August 1, 1978).

[12]Martin Feldstein, "Inflation and Supply-Side Economics, *Wall Street Journal* (May 20, 1980).

[13]Michael K. Evans, "The Reagan-Kemp Inflation Plan," *Industry Week* (April 28, 1980), p. 84.

[14]*Federal Reserve Bank of Minneapolis 1979 Annual Report*.

[15]Paul Craig Roberts, "Caricatures of Tax-Cutting," *Wall Street Journal* (April 24, 1980). This point was also strongly emphasized by Dr. Norman Ture in testimony before the Joint Economic Committee on 21 May 1980.

[16]J. R. Hicks, *Value and Capital* (London: Oxford University Press, 1946), pp. 31–37.

[17]U.S. Congress, Joint Economic Committee, *Tax Policy and Core Inflation* by Otto Eckstein, Joint Committee Print, 96th Cong., 2d sess. (Washington: U.S. Government Printing Office, 1980); idem, *Productivity and Inflation* by William Freund and Paul Manchester, Joint Committee Print, 96th Cong., 2d sess. (Washington: U.S. Government Printing Office, 1980).

[18]Art Pine, "Industry Cutbacks May Feed Inflation," *Washington Post* (May 12, 1980).

[19]Judith Miller, "Budget Debate: Cutting Taxes to Stop Inflation," *New York Times* (March 9, 1980); Editorial, "Feast of the Tax-Cut Free Lunch," *New York Times* (February 24, 1980).

Because we have two lengthy main articles in this issue, "To be governed..." usually found on page 8, does not appear. However, it will appear regularly in future issues.

Supply-Side Economics: Another View

by Tyler Cowen

What do you call a new economic theory that may have the potential to decrease tax rates, increase government spending, balance the budget, and cure inflation? If the theory were capable of achieving these feats all at once, you would most likely be looking at the latest trend in modern economic thought, supply-side economics.

Supply-side economics, broadly defined, consists of two propositions: (1) Fiscal policy produces changes in supply as well as demand; (2) The amount of labor and capital supplied, and hence, productivity, is influenced by the marginal rate of taxation. When elaborated in these simple statements, supply-side economics is highly unobjectionable. Indeed, it focuses on several important points that mainstream economics has overlooked. Many supply-siders have directed attention to some of the classical economists (e.g., Smith, Say) whose contributions were deemphasized by the Keynesian revolution. The supply-siders have also admirably applied marginal analysis to the decisions that individuals make to work, save, and produce. For instance, Michael Boskin's recent work analyzing the effect of taxation on the rate of savings[1] is particularly relevant at a time when America's savings rate has just fallen below 4%.[2]

> **"It is not the basic idea behind supply-side economics as such that is objectionable, but rather how it may be used."**

Of course, a definition of supply-side economics would not be complete without at least a partial list of who the supply-siders are. Arthur Laffer, Martin Feldstein, Michael Boskin, Irving Kristol, Paul Craig Roberts, Michael Evans, George Gilder, and Jude Wanniski are but a few of the more prominent names that have been associated with supply-side economics.

One cannot help feeling suspicious about some of the claims of supply-side economics, however. It is not the basic idea behind supply-side analysis as such that is objectionable, but rather how it may be used. Because there are as many kinds of supply-side economics as there are supply-siders, it is impossible to write a comprehensive critique of the theory, and therefore I will concentrate on analyzing some of the more dubious supply-side theories.

Supply-side economics promises (threatens?) to become the macroeconomic policy tool of the 1980s, just as Keynesian economics was the major policy tool of the 1960s. The problem is that both tools are particularly ill-suited to the task to which politicians wish to put them. The Phillips curve works in the short run, but it was used to pursue long-term goals, such as adequately low rates of inflation and unemployment. The result was stagflation. Although the Laffer curve may operate effectively in the long run, its proponents wish to use it for a short-run goal: balancing the budget. We can only guess at the results of supply-side fine-tuning. After fifty years (at least) of tinkering with the demand side of the economy, the federal government is starting to realize the impossibility of effectively managing aggregate demand. Now the government is about to start fine-tuning the supply side. Although the

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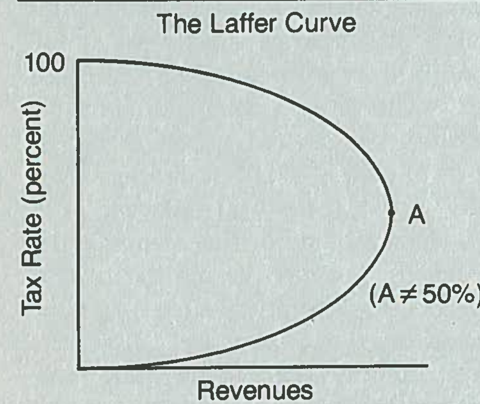
problems of supply-side tinkering may catch up to them in another 50 years, by that time they will have forgotten all of the problems with demand-side tinkering and will be ready to prime the demand pump once again.

The Laffer curve is the linchpin of current supply-side economics. The basic insight behind the Laffer curve is that "there are always two tax rates that yield the same revenues."[3] For instance, either a taxation rate of 0% or a taxation rate of 100% will yield zero revenues. The diagrammatic representation of the curve places the tax rate on the vertical axis and revenues on the horizontal axis. The shape of the curve resembles the right half of an oblong horizontal oval and represents different combinations of tax rates and government revenues. The economic policy maker may be given the task of finding the point of the Laffer curve that maximizes government revenue, but this is not as easy as it sounds, as we do not know either the true shape of the curve or our location on it. The curve is nothing but an imaginary representation of the aggregate results of individual decisions regarding work vs. leisure, saving vs. spending, etc. Since these decisions are essentially of a subjective nature, they cannot be measured. Even if peoples' preferences and expectations were known by the policy maker, they cannot be assumed to remain constant. By the time a tax cut is enacted and begins to take effect, the curve will have shifted considerably.



Another problem with the Laffer curve is that its true shape is not smooth and continuous, as uncertainties and rigidities will produce a "bumpy" curve with many ups and downs. There is even the possibility of two different points of maximum revenue, and the curve may be characterized by all sorts of peaks and valleys. If this were the case, a tax cut might produce *more* revenue while moving the economy further *away* from the point of maximum revenue. The policy maker can never know which way the economy is heading.

"Like most macroeconomic theories, the Laffer curve lacks any discussion of economic processes; it is simply assumed that the economy shifts from one point on the curve to another."

Many of these problems arise because supply-siders have adopted the aggregative macroeconomic perspective of Keynesian economics. Irving Kristol has even admitted that "it (supply-side economics) does retain the Keynesian macroeconomic apparatus for diagnostic purposes...."[4] All of the key concepts behind supply-side economics, such as "productivity," "savings," "investment," and "rate of taxation" are often aggregated into lump-sum figures or rates. The effect of taxation on macro-variables is given priority, but its microeconomic effects are ignored. Productivity in one sector of the economy is treated as equivalent to productivity in another sector. However, when the two "amounts" of productivity are added together, something additional is lost: the meaning that individual actors attached to the disaggregated figures. The resulting aggregates are not relevant to the plans of the market participants, nor do they exert any causal influence on the market.

While supply-side economics raises the question of inadequate gross investment, it ignores the problem of where these investment funds are going. The market's ability to channel investment effectively into the proper areas has seriously been hindered by government policies of inflation, taxation, and regulation, which create distortions in the relative prices, interest rates, and profits that allocate resources. Hence a theory that focuses only on changes in the level of investment and not its composition confronts only part of the problem.

Like most macroeconomic theories, the Laffer curve lacks any discussion of economic processes; it is simply assumed that the economy shifts from one point on the curve to another. There is no discussion of how the shift occurs, how long the shift takes, or what relative price effects are engendered by the shift. These should all be crucial factors in evaluating the effectiveness of a tax cut, yet the current versions of supply-side economics have not provided these insights because they have not incorporated micro-dynamics into the theory. Neither are the supply-side econometricians (e.g., Evans) able to provide this analysis because they are primarily concerned with measuring aggregate economic variables rather than tracing market phenomena back to individual choice.

The most serious drawback with the Laffer curve is that it may be used for the purpose of maximizing government revenue. The track record of the last 200 years of federal spending indicates that this may not be the most desirable goal. Increasing the government's command over resources is likely to have harmful effects, not only in the market and in the international arena but also on our civil liberties. There is nothing necessarily "free-market" about supply-side economics. It could be just as easily used to justify a tax increase as a tax decrease, depending on our supposed location on the curve. Supply-side economists focus on the rate of taxation as a potentially benevolent instrument of policy, to be varied at the policy maker's discretion. In doing so, they draw attention away from the important ethical questions that are raised by *any* level of taxation. One of the major supply-siders, Jude Wanniski, admits that "a welfare state is perfectly consistent with the Laffer curve..."[5] Although we should applaud any theory that advocates an immediate cut in taxes, the supply-siders should be prepared to accept the fact that this may mean a corresponding reduction in federal spending.

If the supply-siders are seriously concerned about productivity rather than government revenue, let us issue the following challenge: Redraw the Laffer curve by replacing "government revenue" on the horizontal axis with "private-sector productivity." Draw a new curve, representing the tradeoff between the rate of taxation and productivity. This curve will have a negative slope, showing productivity at its maximum when the tax rate is zero. *Now* choose the appropriate rate of taxation. ■

[1]See "Inflation, Taxation, and the Rate of Savings," *Journal of Political Economy*, April 1978.
[2]Kenneth Simonson, United States Chamber of Commerce, public speech, May 28, 1980.
[3]"Taxes, Revenues, and the "Laffer Curve," *Public Interest*, Summer 1978, Jude Wanniski quoting Arthur Laffer, p. 3.
[4]Irving Kristol, "Toward a 'New' Economics?" *Wall Street Journal*, May 9, 1977.
[5]Wanniski, p. 16

The question of tax cuts will play a large role in this year's presidential election. In this issue, *Policy Report* has presented a debate on supply-side economic analyses, the theoretical foundations for many current policy proposals. We have presented this debate as a service to our readers. The opinions expressed are not necessarily those of the newsletter.

Briefs

☐ One reason why the unemployment rate is so high is that workers are able to receive such substantial unemployment benefits. Although 1.7 million workers have been laid off since March, with another 600,000 to come, many will be living quite comfortably. Unemployment insurance and supplemental private benefits may add up to as much as 95% of previous take-home pay.

☐ Last year federal loans, either direct, guaranteed, or assisted, added up to 17.9% of all outstanding loans from the period September 1979–September 1980. Government-backed lending is expected to increase by $72 billion this year, bringing the outstanding balance up to $601 billion by September 30, 1980. The largest lender is the Federal Housing Administration, which has lent $120.1 billion this year; the Veterans Administration is a close second at $100.9 billion. The Office of Management and Budget estimates that this year's borrowers have saved approximately $26.7 billion by going to Uncle Sam. One might ask whether these loans are sound if the federal government's assistance is required.

☐ Another example of a Federal regulation that backfires on lower- and middle-income groups can be found in Vermont. The Department of Labor is in the process of enforcing a section of the Fair Labor Standards Act of 1938, which mandates that knitted outerwear may be produced only in factories. The law was originally intended to curtail sweatshops in New York City tenements, but it is now on the verge of destroying the healthy cottage garment-making industry in Vermont. One elderly woman whose livelihood is making hats in her home summed it up nicely when she said, "I think the government should keep its nose out."

☐ The July 14, 1980 issue of *Business Week* shows the results of a survey of the recent performance of econometric models. In the last quarter of 1979 and the first quarter of 1980, the consensus of the eleven models examined was that real gross national product would decline approximately 2% to 3%. In each quarter real GNP rose slightly. The second quarter of 1980 showed a decline in real GNP of 8%, although the models predicted a decline of only 2%. The new forecasts for the remainder of 1980 show dips of from 1% to 4%, although in 1979 these models predicted increases of up to 3% for this very same period.

☐ The Ford Motor Company has fired its chief economist, William Niskanen, for his opposition to the company's new protectionist stance on foreign imports. Ford has been quick to follow in the footsteps of the Chrysler Corporation and suggest a "partnership" with the federal government on matters of financing and tariffs. Niskanen properly points out that Detroit's problems are *not* traceable to foreign imports and opposes protectionist legislation. When informed of his dismissal and told that the proper policy for a corporate economist was to support management positions, Niskanen remarked: "That's not my style."

☐ Donald Lambro's new book, *Fat City: How Washington Wastes Your Taxes* is a forceful 405-page polemic against the waste and extravagance of the federal government. The purpose of the book is summed up on the inside jacket: "*Fat City* is a taxpayers report showing specifically how, where, and why the U.S. government misspends our money, and how it can reduce the amount it wastes. Instead of $40,000 for Congress' floral service, $4.8 million for chauffeured VIP limousines, and $1 billion for fat consultant contracts, the money could be used to increase the weekly take-home pay of working Americans." ■

✓Washington Update

✓President Carter has recently signed the Energy Security Act, a bill designed to round out his energy program by creating incentives for the production of synthetic fuels. The bill authorizes the federal government to spend up to $88 billion in the next dozen years, primarily to encourage private ventures that otherwise would be too risky. The new Synthetic Fuels Corporation will apportion loans to those companies that develop promising synfuel projects. The bill also mandates increased expenditures on solar and geothermal energy, alcohol fuels, and stipulates the daily addition of 100,000 barrels of oil to our strategic petroleum reserves.

✓A new bill has been introduced in Congress that would exempt from taxation most or all of the income that U.S. citizens earned abroad. The purpose is to encourage Americans to take foreign jobs that would help American trade. The exemption would cut taxes by approximately $500 million.

✓The Rehabilitation Act of 1973, which outlawed discrimination against the handicapped, is going to cost taxpayers far more than anyone ever realized. A Congressional Budget Office report estimates that compliance with the requirement that bus and subway systems be made accessible to those in wheelchairs will cost $6.8 billion over the next 30 years—more than double current annual federal transit spending. Also, although all colleges and universities are already supposed to have made their programs accessible to people in wheelchairs, fewer than half have done so. Proposals to amend the Rehabilitation Act are already gathering suppport in the Congress.

✓The House of Representatives has recently voted down a proposal that would continue the Environmental Protection Agency's authority to regulate pesticides. The bill would have allocated an additional $72.2 million to the EPA for the study and regulation of pesticides. The vote is considered a signal that the House wants congressional veto power over EPA decisions.

✓The Administration is being urged by auto companies and the United Auto Workers not to overturn a decision by the U.S. Customs Service raising the effective tariff on imported light trucks from Japan to 25%. The U.S. firms expect the higher prices to increase demand for slightly larger U.S. models. Free trade proponents fear this may be the opening round in a new protectionist trade war.

✓Nearly everyone on Capitol Hill agrees that President Carter's fiscal 1981 balanced budget will be impossible to achieve with unemployment near 8% and the defeat of Carter's proposed $10 billion oil import fee. An election-year tax cut is now considered likely. The projected deficit for the current year has swollen to $46.5 billion from $23 billion, but even that figure may be too low once outlays to assist Cuban refugees and victims of the Mount St. Helens volcano eruption are added in.

✓President Carter's proposal to introduce tax withholdings on interest and dividend payments has been met with surprising opposition in the Senate. Sen. John Chafee (R-RI) has obtained 58 cosponsors for a resolution blocking the proposal. The added withholding would raise an additional $3.4 billion in fiscal 1981 with over two-thirds of that coming from interest on the accelerated payments.

✓President Carter has signed legislation that would cut social security benefits an average of 14% for those going on the rolls after July 1980. The bill attempts to avoid paying benefits so high that families of disabled workers would be paid more than the workers earned before being disabled. In 1970 some 2.7 million people received disability benefits at a cost of $3 billion. Now more than 5 million are on the rolls, and costs will exceed $17 billion in fiscal 1981.

✓The federal matching funds program has already spent $14.2 million on presidential candidates that failed to capture their party's nomination. Reagan, Carter, and Anderson have already been given $12.8 million for their primary campaigns. Carter and Reagan are already eligible for another $29.4 million, while each major party will receive $4.4 million for their convention.

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