SUPPLY-SIDE ECONOMICS: A SKEPTICAL VIEW

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The current buzzword in Washington--and one presumes in Denver, San Diego, and South Bend as well--is "supply-side economics." Since a significant number of economists seem to be lining up behind its flag, it would be worthwhile to take a hard look at the current rage.

The new emphasis on the supply side should be applauded. We have too long been concerned in our economic policy with questions of demand management, much to our loss. The one area in economics which has traditionally concerned itself with questions of supply is what we term "economic development" which deals generally with problems of Third World countries. Perhaps one peripheral outcome of supply-side economics will be to give development economics new prominence!

Supply-side economics has taken on added importance with the advent of Reagan administration. Although the administration's proposals are of great interest, they are not strictly in accord with what can be called "pure" supply-side economics which we wish to focus on here.

In appraising supply-side economics, there are two points to be made. First, pure supply-side economics will not work as a solution to the ailments of our economy. This will be elaborated below. Second, there are many approaches to supply, some having a greater likelihood of success than others. A quote from George Gilder's book, *Wealth and Poverty*, aptly demonstrates the variety of approaches. The book could appropriately be subtitled "the supply-side manifesto." Speaking of the inheritance of wealth by children of the wealthy--those on whom resources have been lavished in their education, health, and so on--Gilder says:

> The receipt of a legacy, it turns out, often erodes the qualities of entrepreneurship that are needed to perpetuate it. Spending turns out to be far easier than choosing and maintaining those select forms of capital with yields greater than their costs. [5, 1981, p. 56]

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Now the implications of this view from a supply-side perspective is that there should be heavy inheritance taxes to induce these capable and lavishly endowed children of wealth to contribute to the social product. This is supply-side economics. Yet, the Reagan administration with its avowed supply-side orientation wants to lower such taxes. It should be noted that Gilder does not advocate a 100 percent estate tax. The point, however, is that there are a number of different approaches to increase supply, and it might be interesting to ask why we choose one over another.

The current pure approach of supply-side economics advocates social expenditure cuts, deregulation of industry, and tax cuts. According to pure supply siders such steps will not only increase supply, lower unemployment, and slow inflation, but will also reduce the Federal deficit. Although these conditions may not be obtained immediately, they certainly will be in the long run.

To begin to point out the difficulties with this scenario, let us refer to a new variant of that timeworn story about the economist and metallurgical engineer stranded on an island. They are starving and have a large can of Dinty Moore beef stew, but no can-opener. The engineer, familiar with the materials in the can, found a number of reagents and planned a way to treat the can to bring about its decomposition allowing easy opening. The economist, who happened to be a pure supply sider, had another solution: "Let's assume that we find a can-opener--in five years!"

There are three basic reasons why pure supply-side economics will not get the can open: first, the absence of an empirical basis; second, its own internal contradictions; and third, its choice of horses to carry its banner.

The empirical basis offers little evidence to support strong confidence in supply-side prescriptions. One macro model has been touted as showing the beneficial effects of a supply-side program on saving, work effort, investment, and so on. Unfortunately, that model has never been published; in fact, one sponsoring organization has stated that the data had been scrapped [4, 1980, pp. 13-14]. Indeed, it seems that supply siders have had some difficulty in formulating a macro model. David Stockman found that when his expenditure and taxation plans were fed into the Congressional Budget Office model, the results were unacceptable (because of budget deficits of $70 to $80 billion). Stockman turned to an economic model developed at the Claremont Economics Institute, but that too, proved to be unsuitable. Finally, he teamed up with aide Lawrence Kudlow to construct what has been described as a "framework for constructing general economic 'scenarios'" [1, 1981, p. 66]. The various assumptions in the "framework" apparently produced what Stockman had been after--an indication that implementation of the Reagan program will lead to growth of four percent per year, and by 1983 a balanced budget and inflation rate of five percent. Including these claims as assumptions, however, is far from providing evidence in their favor. But is there evidence from smaller studies of supporting particular components of the analysis?

It would not be possible to summarize all of the evidence on all of the components, but let us look briefly at the effect of taxes on saving--a key factor if investment and output are to increase. Michael Boskin found that there was an interest rate effect on saving [2, 1978, pp. 3-28]. His results are not very robust, as Howrey and Hymans showed [5, 1978, pp. 655-85]. By dropping one year, 1934, his results washed out. Although Boskin had a comeback, Mieszkowski had the last word. He concluded that there may be some interest and tax impact on savings, but it is essentially irrelevant to the key welfare and efficiency issues [7, 1980, pp. 203-20]. In any case, at this level there may be some evidence but it is far from persuasive.

What about other less formal types of evidence? The *Wall Street Journal* has always maintained that you increase tax receipts by cutting taxes thereby stimulating the economy; they find evidence for this in the 1964 tax cut and more recently in the capital gains tax cut carried out in 1979 causing a very small decrease in tax receipts [10, 1981, p. 20]. Even the *Wall Street Journal* admits that such evidence is at best partial, but it certainly must be taken seriously, and if noticed in other contexts would provide empirical support for supply-side propositions.

Turning to a much larger context, some relevant information can be gained from the experience of countries which have attempted their own version of supply-side policies. In general the experience is not very hopeful. Britain has fared so poorly that even the *Wall Street Journal* is attempting to dissociate itself from identification with the Thatcher government. In Chile, Uruguay and Argentina, not to mention Israel, there may have been some success in getting the economy to grow, but inflation has not fallen, unemployment has generally risen, and the wave of bankruptcies continues to ripple. Indeed, the successful countries of the world, such as Japan and Germany, seem to have gone directly against the types of programs suggested by pure supply-side economics. So the experience elsewhere is hardly reason to place reliance on supply-side policies.

A second problem with the pure supply-side approach is that it is internally inconsistent in several respects. The first is its new claim to the "trickle down theory" which holds that if income is distributed to the wealthy, the resulting increase in supply will finally lead to an improvement in the welfare of the poor. If there is one lesson of development economics, it is that this simply does not occur. Incomes under trickle-down regimes show no tendency to become more egalitarian. In many cases, the incomes of significant sectors of the population have actually deteriorated. It is likely that either an absolute or relative deterioration in income has disincentive effects and actually lowers worker productivitiy. Business firms are very careful about their internal relative salaries because of the impact on work effort, but here we have a program which expects the poor and lower middle class to work harder as their relative income position worsens. It just will not happen.

A second contradiction is in the area of cuts in entitlement programs as a means to gain control over the Federal budget. Planned budget slashing in that area has been more than offset by planned increases in defense spending and tax cuts. For fiscal year 1982 the Administration proposes to slash nondefense spending by some $40 billion, increase defense outlays by $30 billion and cut taxes by $46.6 billion. The end result is an added stimulus of $46.6 billion. Furthermore, through fiscal year 1986 the Reagan plan calls for a $138 billion cut in civilian expenditures against a $181 billion increase in defense expenditures and a $196 billion tax cut [9, 1981, p. 3]. Clearly, these initiatives will not lead to greater control over Federal spending. But note that we will be substituting one form of automatic increase--military obligations--for another, social service entitlements. We will simply substitute the criticism of cost overruns for the criticisms of fraud and waste. The economic impact of defense entitlements is not likely to be any better than social expenditure entitlements.

The final contradiction is the emphasis on deregulation of industry, a view based on the assumption that perfect competition and its theoretical benefits are the likely outcome.

To see the difficulties with this we have only to turn to the airline industry which was rapidly and effectively deregulated over the last three years. The results of the deregulation of the airlines are less than hopeful. It is difficult to parse out the various effects of increased jet fuel cost, recession, and so on, but there is little evidence that the magical results hoped for have actually occurred. Prices of airline fares were very stable during the 1970s, rising by only 33 percent from 1973 to deregulation (in the face of massive increases in fuel prices). But from then on they accelerated at a pace double the consumer price index, increasing 29 percent in 1979 and over 30 percent in 1980. Simultaneously, service to small communities deteriorated having little effect on the load factor for the industry, industrial concentration increased as mergers were undertaken (although commuter lines have increased), passenger revenue miles dropped, and finally profits fell [8]. The experience of expanding deregulation efforts does not bode well for this component of supply-side economics.

Let us turn now to the third problem, the horses that will carry the supply-side banner. The primary horses are the wealthy and the entrepreneurs. The experience in Latin America suggests that supply-side policies there did not make the wealthy work harder or save more. Why should this be different in the U.S.? It is also unlikely that additional entrepreneurs will be brought forth. Indeed one of the interesting aspects of Gilder's book is the number of cases cited of existing new entrepreneurs. Somehow our system seems to allow entrepreneurs to emerge despite what the regulatory environment may be.

The second insecure horse is "fortress America." There is a myopic tendency to overlook that the U.S. is now more than ever an open economy: overseas shocks will necessarily force domestic adjustments, foreign markets and sources of goods are increasingly important, and that complete openness to competition may lead to losses of domestic supply in certain industries [3, 1980].

And finally, supply-side economics is betting on the business firm, i.e., the business sector, which may be unfounded. Hayes and Abernaty have written that falling productivity cannot be blamed on government, unions, and the like; rather, it rests squarely with the U.S. corporation and the type of manager who makes his or her way into the upper echelons [6, 1980, pp. 67-77]. To summarize, it is the financial analyst seeking short-run goals who reaches the top rather than the production specialist concentrating on long-run growth; this leads to an inability to compete on technological grounds. Technology is where the dynamism of our economy is generated.

For these reasons pure supply-side economics simply will not work in the U.S.

Let us turn now to a different approach, one which is less pure, more eclectic, but less idealistic and therefore less open to the hypocrisy of the pure supply-side approach.

1. Internationalize our supply-side thinking: First of all, we must realize that our demand-side policies during the 1970s

came to be heavily influenced by foreign pressures. They were important in forcing the Nixon wage-price freeze and more recently, they played a role in the Volcker and Fed change in monetary policy (October, 1979). They will also affect any supply-side policies which might be adopted. Whatever we do on the supply side could easily be offset by policies of other nations and indeed by any domestic policy which changes the value of the dollar. The difficulties in affecting our own domestic economy by such policies are pointed out graphically when we realize the substantial importance of foreign operations to our banks or our major business firms. Supply-side policies may simply not fit into our trading partners' strategies, making our policies entirely ineffective unless carefully thought out.

One corollary has long been known in Third World countries. This is the crucial nature of increasing supply in what we call wage goods, those goods consumed by the mass of the population. For in that fashion international competitiveness can be maintained and limits to required wage increases can be found. This means for the U.S. that we need to increase our supply of food, housing, and transportation. Since this will probably not occur, prices will continue to rise and supply will continue to be sluggish.

2. Incomes Policy: The Reagan program has an implicit incomes policy, an effort to change or set the distribution of income (or at least expenditure) by government policy. The deregulation of oil, the eventual form of tax cuts, and the expenditure cuts all impact the poorer segments of the population. The planned expenditure ceilings will do the same over time as well. We should realize that most of the countries we compete with have much more equal distributions of income, and it is not by chance that they seem to be performing better, for the distribution question affects behavior and production. It is true that reliance on transfers to equalize consumption is not effective in the end, but we should only replace them if we can generate income-earning opportunities. Cutting transfers immediately will not open up the jobs required. Thus we should actively attempt to create more jobs, and link the incomes of various groups in society to our success in doing that. If we cannot provide jobs, we should still provide the consumption power, but in a clear linkage to our ability to provide employment. Such an incomes policy attempts to increase the number of jobs while lowering the disincentive of wide income differentials and the deterimental impact of transfers. It should be noted that only if their incomes policy restrains demand will the Reagan administration have an effect on prices for the next few

years.[1] Tight monetary policy is unlikely to have the desired effect because credit expansion can occur and because the policy will push up costs of production and therefore prices. Higher interest rates will also reduce capital formation, tending to restrict future supply.

3. Deregulation: We do not need deregulation for the sake of deregulation. The airline industry is a good example. Government activity in the economy did not arise by accident, but in response to needs. However, it is time for a consistent reevaluation of the regulatory apparatus, and an examination of the costs and benefits of various regulations. Conditions change and regulations should change with them. We should not attempt to impose a competitive model on our industries. That is fine in theory but not in practice, as many economists since Adam Smith have known. We should bring the interested parties together to begin to make adjustments that will aid in increasing supply but will at the same time ensure that the benefits of regulation are maintained. This seems to be the approach used in Japan where consensus of a broad nature is a goal of public policy.

4. Finally, we should be venturesome in what we undertake and in what our government supports. The governments of Germany and Japan are intimately involved in a type of economic planning, and there is no reason that the U.S. could not do the same thing. Perhaps we do not want to finance such efforts out of general revenues, but we could allow individuals to make a contribution, or an investment, in a U.S. venture capital fund by simply adding it to their income tax payment. If vital projects can be found, we should be able to awaken the enthusiasm of the American people.

In addition, Germany has brought workers into a direct role in decision-making. We should seriously investigate these possibilities. Indeed, we should be willing to look at new forms of organization such as workers ownership. It was the Federal government which backed the purchase by employees of South Bend Lathe, a firm which was to be liquidated but the profits of which rose 25 percent in the first year of employee ownership and have generally risen since. We cannot be put off by efforts such as that of the Youngstown coalition to purchase the closed steel mills. But, certainly such efforts should be encouraged in newer, more dynamic industries.

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[1]Note that we are speaking of the effect of supply-side policies, not external factors such as international price declines for oil. Indeed these positive supply shocks which might occur idependently of any policy program may be the best hope for success of current efforts.

Finally, one of the lessons of countries such as Taiwan and Korea which have grown rapidly and equitably in the postwar era is the centrality of wide access to productive assets. Efforts to allow access to land and other productive assets should be encouraged. This calls into question relying solely on the existing corporate structure and its managers, which returns us to the points in the *Harvard Business Review* article [6].

We need increased emphasis on supply, but these questions are too important to be left to the pure supply-side economists.

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