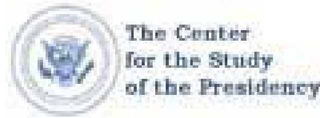


Guest Editorial: Supply Side Economics

Author(s): C. Lowell Harriss

Source: *Presidential Studies Quarterly*, Spring, 1982, Vol. 12, No. 2, Seperation of Powers and the Power to Govern: With Particular Reference to the Truman-Eisenhower Legacies (Spring, 1982), pp. 268-272

Published by: Wiley on behalf of the Center for the Study of the Presidency and Congress

Stable URL: https://www.jstor.org/stable/27547812

JSTOR is a not-for-profit service that helps scholars, researchers, and students discover, use, and build upon a wide range of content in a trusted digital archive. We use information technology and tools to increase productivity and facilitate new forms of scholarship. For more information about JSTOR, please contact support@jstor.org.

Your use of the JSTOR archive indicates your acceptance of the Terms & Conditions of Use, available at https://about.jstor.org/terms

*Wiley* and *Center for the Study of the Presidency and Congress* are collaborating with JSTOR to digitize, preserve and extend access to *Presidential Studies Quarterly*

This content downloaded from
149.10.125.20 on Fri, 21 Jan 2022 22:25:02 UTC
All use subject to https://about.jstor.org/terms

# GUEST EDITORIAL
# SUPPLY SIDE ECONOMICS

*by*
**C. LOWELL HARRISS**
*Board of Editors*
*Presidential Studies Quarterly*

New terms can lead to fruitless or to fruitful discussion. "Supply side" has become associated with politics, and debate can quickly move from a scholarly plane to the partisanship of politics. Issues of vital importance are involved.

Which blade of the scissors does the cutting? The answer must be—both, though one may be sharper than the other. In economic affairs the question is whether demand or supply determines output and price, and the answer is that both operate. Both deserve attention in economic analysis, in business affairs, and in public policy.

As some professional economists began not long ago to try to emphasize "supply side," they reflected a belief that for many years inadequate attention was given to supply, compared with that accorded to demand. And "demand management" has certainly fallen short of producing the successes once expected and has contributed to the dollar's loss of value through inflation.

During the Great Depression of the 1930's so much labor and other productive capacity was unused that the dominant problem seemed to be lack of money demand. Total money demand, buying power, was too small to purchase the full potential output of the economy at prevailing wage rates and prices. Moreover, prices and wage rates failed to go down enough to get in balance with "low" money demand and bring full employment. A solution appeared possible. Government could add to money demand by creating new money through the banking system. Newly created funds could finance a Federal budget deficit. The deficit could be realized by tax reduction, expenditure increase, or some combination of both.

This emphasis on demand gave support to increases in the stock of money. The increases, whether or not deliberately arranged to enlarge demand, have for many years been followed by a decline in the purchasing power of the dollar—inflation. Of course, total supply has increased as demand has risen. Output today, due in part to a rise in employment of more than 30 million in twenty years, provides a higher level of living than Americans enjoyed not so long ago. But on the average, living standards have not improved the way most of us want. We all know that unemployment in tragically high despite monetary expansion on a "not small" scale and large budget deficits.

The chief emphasis and concern of "supply side" are for the longer run. Policies have immediate results—sometimes apparently negligible (1981 tax changes to go into effect in 1984)—and long-term results. The latter develop in a complex world where many forces will be unexpected.

Some increases in production can always be obtained by injections of money demand. Economists emphasizing supply, however, believe that Americans cannot achieve reasonably adequate living levels without improving the conditions of supply—especially over the longer-run. And those who cite and act upon the quip, "In the long run we are all dead," do a disservice. In any meaningful sense life goes on. Our grandparents may not be alive, and our grandchildren may not yet be born. But life continues.



This content downloaded from
149.10.125.20 on Fri, 21 Jan 2022 22:25:02 UTC
All use subject to https://about.jstor.org/terms

### The Supply-siders' Views

Supply-siders believe that positive actions can be taken to improve the conditions of supply and thereby raise living standards. The specific proposals, and the relative importance attached to each, will differ from one economist to another. In fact, "supply side" as a designation lacks precision. Economists endorsing the concept will emphasize different elements and may be in conflict on some.

Faith in the effectiveness of the price mechanism when it can function freely "on its own" constitutes an element which some advocates of supply-side economics rank as possibly the most important. Productive resources will become available, and be used at prices which will reflect, (1) on the one hand, the value of alternative opportunities and, (2) on the other hand, productivity, as measured by the worth to consumers. Idleness will be less desirable than employment. Rewards affect choices. If market processes can operate, they will bring about results—over the long run if not immediately—which are better than those which in fact come about when "demand management" (through fiscal and monetary policy) introduces changes, creates uncertainty, brings surprises, and in fact generates inflation.

The conditions of supply governed by relative prices will reflect balances on the two sides—demand and supply—which represent the valuations of the parties. Markets are fundamentally stable, it is believed, and if left to themselves will lead to a better allocation of resources than can be attained under any alternative. Monetary change, however, cannot be left to itself. It can create instability and distort the allocation process. Debate on the best type of monetary policy will be found among supply siders.

### The Public Policies

What aspects of public policy are involved? (1) One set of proposals would seek to increase the amount of production capacity of various kinds. (2) Other proposals deal with the conditions for using production capacity. Most attention focuses on things government can do, or is supposed to be able to do.

The prospect of rewards affects what most of us will do. We respond to incentives. Tax-rate reduction, it is believed, would improve incentives and help to increase the total of labor available to produce and also the quality of capital.

The market place will enable the employer to incur employment costs equal to the value of what workers produce. Income and Social Security payroll taxes, however, take part of that value—skimming right off the top. Until recently most American workers were not subject to "high" rates on the top of their earnings—what we call the "marginal" or "incremental" tax rate. Federal plus state income and payroll rates were under perhaps 25 percent for most employees with rather few in the 50 percent range. Partly because of inflation, however, more and more persons—individuals and married couples—have arrived at the point where some income is taxed at 40 to 50 percent.

If taxes drive a "wedge," say well over 40 percent, between the top dollar of earnings and what a skilled worker, professional person, or executive can take home, then some will choose more leisure as against quite so much work and production. Longer vacations, earlier retirement, more absenteeism, and, especially for second workers in a family, gaps between jobs, all these will cut the effective supply of labor. Reducing marginal tax rates, it is argued, will improve the incentives of some persons to work more and better during their lifetime. Some of those affected the most will be persons with the highest productivity; their incremental earnings are subject to tax rates far above average.

The practical political problems of reducing taxes complicate matters. Most workers will probably not work more if marginal taxes (income and payroll) are reduced from, say, 27 to 20 percent. It is at higher ranges that one would expect the incentive stimulus to appear. But to reduce the high bracket rates (where little revenue is involved) it seemed necessary to reduce rates on lower brackets where the large tax base leads to large revenue and budget effects.

National plus state taxes on busi-

This content downloaded from
149.10.125.20 on Fri, 21 Jan 2022 22:25:02 UTC
All use subject to https://about.jstor.org/terms

ness—especially successful companies—have come to impose heavy burdens. Tax rates (Federal plus state) come to 50 percent or so on incremental earnings of corporations responsible for much of American production. Moreover, deductions for depreciation and obsolescence have been grossly inadequate for an economy in which inflation makes replacement cost much greater than original (historical) cost. Supply-side economics would emphasize the folly of such taxation. Reduction in explicit tax rates offers one means of reform and has been enacted for most corporations but not for major firms. Change in depreciation—capital consumption—allowances offers another—and along with changes in the investment tax credit were the choice of the 1981 tax law. However, what are truly substantial changes take effect only gradually. The great mass of existing capital will suffer (grossly) excessive taxation because of inflation.

How influential will tax changes be? No one will ever be able to pinpoint the results of one element in a complex world. Underutilization of existing capacity obviously reduces incentives to add even for cost-cutting purposes. The short run and the long run differ.

### Capital and Savings

Capital is needed for economic progress. Production facilities, including housing, require the use of labor and resources which will be available only if we do not consume *all* of our income. Some of each year's income—production—must go into capital rather than consumption goods, if new and better equipment is to enable us to raise living standards. But Americans have been saving rather small percentages of their incomes.

Supply-siders point to one reason for low saving: the net rewards after tax can be slight indeed. Of course, families with small to modest incomes do not face high marginal tax rates; these families have only limited ability to save. When subject to tax, they have been granted no adjustment for inflation so that they pay tax on interest from a savings account even when their real wealth has gone down.

The families which have more income and capacity to save face discouraging prospects (even ignoring inflation). If they sacrifice somewhat more of current consumption and put the funds saved into, say, thrift institutions which finance new housing, the yields have been cut by over 70 percent at the extreme and by 40 to 50 percent in many more cases. Taxation has a big effect on what remains for savers. Supply-siders believe that in many cases potential savers have been discouraged by high tax rates.

The issue is not only the size of this year's disposable income but also the net benefits obtainable from additional saving. Is it not logical to conclude that consumption in the present is more attractive than consumption later with the small increase possible when half or more of the fruits of added capital are appropriated by government?

Reducing tax rates, therefore, is supported as a means of adding to the economy's capital base by encouraging thrift. The after-tax benefit—the incentive—can be enlarged significantly by a change in tax rates. The 1981 law in effect grants a zero rate currently on certain new savings for most Americans by generalizing and expanding the permission to use Individual Retirement Accounts and Keogh Plans.

For nearly two generations the United States has had a tax system according to which families with large incomes faced very high marginal tax rates. These have been reduced substantially. It is not possible to determine how much, if at all, the rate reduction will encourage saving, but supply-siders believe that funds for capital formation will grow. The *immediate* results cannot be large relative to the total flow of saving. Time is required to convince people that conditions have changed and that they should alter their behavior significantly. Moreover, without recognition of the eroding effects of inflation on the capital base, the real tax burdens are much higher than lawmakers are likely to admit.

The entrepreneurial spirit plays a key role in economic growth. Space limits preclude adequate discussion. One point,

This content downloaded from
149.10.125.20 on Fri, 21 Jan 2022 22:25:02 UTC
All use subject to https://about.jstor.org/terms

however, can be noted. Capital gains can play an important role in incentives. Tax laws have reduced the burdens on capital gains—and yet fail to make any adjustment for inflation.

#### Regulation

Getting better performance from the economy—more of what we truly want from the productive facilities available—will be one way to improve levels of living. Recently there has been growing agreement that governmentally imposed regulatory requirements have hurt the processes of production. Regulations have grown at a rapid pace and usually without clear indication of costs as related to benefits. There is general acceptance of the conclusion that burdens in some cases have been greater than the benefits. The economy could supply us more effectively if many regulations were revised—and could do without loss of equivalent benefits from the change in regulation. Selecting which regulations to change, however, and in what ways must present great difficulties. In most cases some costs are easily measured, but some are not obvious. Very often the benefits, many of which are intangible, cannot be measured with any reliability, especially those spread over several years.

How large could be the possible contribution of regulatory reform to the improvement of supply? Views will differ considerably. But a start began several years ago. New impetus should speed reexamination. No miracles are to be expected. Results will be diffused over the country and its many industries. Some consequences will be the avoidance of future actions which might be either not constructive or too costly.

#### Monetary Policy and Inflation

Supply-siders are likely to criticize demand management as it can be practiced and perhaps the underlying theoretical analyses. Monetary policy as it has actually functioned has contributed to the declining purchasing power of the dollar, a rising price level. Inflation disrupts the economy. Past economic relationships are altered for reasons other than the opportunity to improve terms of specific market transactions. Uncertainties about the future worth of the dollar create obstacles for judging what will be best for the months and years ahead. Business arrangements involving the future take on new risks. The changing—the eroding—value of money makes for poorer economic performance. Therefore actions to reduce and eventually to eliminate inflation are an important part of the total package of actions to improve the economy; the package requires new approaches.

Supply-siders believe that monetary policies designed to implement demand management create instability in the production economy. The reasoning runs as follows: The Federal Reserve in fact accelerates and then slows down the ability of banks to increase their loans. The unevenness of these actions has made for a "stop-go" instability in the economy. Uncertainties and unsettling changes are created by actions which are designed to give a push to business at one time and to slow it down at another. But the Federal Reserve cannot "fine-tune" the massive American economy. In fact, what it has done for better short-run adjustments has often created awkward disturbances. Would not more stable monetary policy have resulted in a more efficiently operating economy? Interest rates have come to the center of attention. Savers, I suppose, welcome high rates, and we can welcome increased supply. Borrowers dislike them. What will monetary actions today do to influence the level of rates next week and next year and five years from now? We have less basis for assurance than most of us perhaps assumed not so long ago.

#### Wage Costs

The quantity of person-hours of work demanded will depend upon aggregate money demand relative to total employment costs per hour. Short-run elements, of course, influence whatever exists at any time. Adjustments in the labor market cannot be expected to offset quickly the influence of all the many forces that operate. Space limits do not permit me to expand on what seems relevant to a discussion of supply. "High" and rising

This content downloaded from
149.10.125.20 on Fri, 21 Jan 2022 22:25:02 UTC
All use subject to https://about.jstor.org/terms

wage rates will tend to keep the total supply of labor utilized lower than would otherwise be the case. Market forces in labor markets operate imperfectly. (What would be perfection?)

Productivity itself deserves a full symposium (or many). Supply-siders, I believe, are likely to attach more importance to wage costs than was customary until quite recently. Import competition has brought the issue into prominence. Obviously, the human factors amplify the need for improved conditions.

### Property Tax Reform to Aid Investment

Tax burdens on new investment projects include local property taxes. They vary widely from one community to another. Often they will be three percent a year—sometimes appreciably more—on full value. In relation to net earnings this annual cost (a fixed expense payable in cash) must be an obstacle to increasing the supply of business and residential facilities.

An alternative means of obtaining local government revenue would improve the opportunities. The effective tax rate on land would be increased to permit reduction of the rate on man-made capital. The amount of land in an area is fixed. It will not move to another community. The quantity of land which owners make available, however, will tend to be greater, not smaller, the higher the annual tax.

The present practice of enlarging tax burdens when someone improves a property must discourage the supply of just the new and better capital goods which a progressive society will desire. The public could change the property tax structure to preserve the yield needed by local treasuries while removing an obstacle to the supplying of more and improved production capacity.

### Concluding Comment

Economists who consider themselves supply-siders do not agree on all points. General accord on important principles does not lead to a single body of doctrine covering specific elements of a large range of subjects. What one person may hold as highly important may seem of only slight significance, or perhaps even wrong, to another.

Measurement presents problems. There will be policies which many agree will have results along certain lines, but there can be honest uncertainty about their magnitude. Advocates may overestimate the desirable consequences. For example, it is clear that income taxes of 100 percent at the margin would certainly deter effort and thrift. Reducing such a rate to 70 percent would have stimulating effect. Reducing a 70 percent rate to 50 percent should have some of the same kind of results. But to what extent and over what time span? How much in one year and how much in ten years?

The discussions of professional economists will continue to consider the issues raised by the supply-siders. Whatever the balance of conclusions, the focus of greater attention upon supply elements can help in the making of governmental policy.

This content downloaded from
149.10.125.20 on Fri, 21 Jan 2022 22:25:02 UTC
All use subject to https://about.jstor.org/terms