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Author(s): ALAN REYNOLDS

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ALAN REYNOLDS

How Supply-Side Triumphed

Postponing the tax cuts and pursuing monetarism delayed our recovery and inflated the budget deficit. Events of 1983-84 show how much American enterprise responds with even modest supply-side help.

It seems almost forgotten, but when the Reagan team surveyed the economic problems it had been handed by the Carter Administration, it was not optimistic about how quickly things could be turned around. The Reagan Administration's "rosy scenario" of 1981 actually forecast a *recession* in that year, a weak 5.2 percent recovery in 1982, and about 4 percent growth thereafter. The latter were remarkably modest objectives, which required only two things that did not happen: sticking to the original Kemp-Roth schedule of cutting personal tax rates by 10 percent in 1981 and 1982, and pursuing a reasonably gradual Federal Reserve tightening. There was a fork in the road, and taking the wrong turn made a great difference to the actual results. Had we stayed on the original path, the 1983 recovery surely would have occurred in 1982, and that earlier recovery, according to the Office of Management and Budget (OMB), would have produced a budget surplus in fiscal 1985.

The failure to permit recovery in 1982, rather than 1983, accounts for the *entire* estimated 1985 deficit, so that deficit must be entirely cyclical, not structural. Separate studies by Robert Barro and Brian Horrigan likewise find that a deficit of around $160 billion can be completely explained as a hangover from inflation and below-normal real growth.

The disaster of delayed tax cuts

In order to evaluate the actual impact of tax reduction, it is obviously essential to know *when* federal tax rates were reduced. Table 1 shows that average tax rates *rose* in 1981 and that personal tax rates in 1982 were still higher than in 1980. Inflation continued to push people into higher tax brackets, and the Social Security tax was increased. In the calendar year 1983—the start of the recovery—personal and overall taxes were finally reduced to the average of the 1970s.

ALAN REYNOLDS is Vice-President of Polyconomics, Inc.

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The "Laffer Curve" never claimed that such a modest cut in tax rates would instantly raise taxable income enough to offset any revenue loss. The claim was instead that dynamic gains in economic growth over time would reduce spending on subsidies, transfer payments, and bail-outs, while raising revenues from other (including state and local) taxes. At a minimum, the Laffer Curve demonstrates that ever-increasing marginal tax rates yield diminishing returns. The OMB and Congressional Budget Office (CBO) static estimates of the revenues "lost" by the tax cut are simply wrong—they still assume that much higher tax rates would have had no adverse effects.

Even the Urban Institute is complaining that federal spending rose "as a percentage of GNP" from 1980 to 1982. That was not because Reagan and Stockman were big spenders, but because private GNP *fell* in 1981-82. In the fourth quarter of 1980 federal spending was up 18.6 percent from a year before; by the fourth quarter of 1983 that annual increase had been trimmed to 3.2 percent.

In the first ten months of fiscal 1984, tax revenues were rising at an 11.5 percent pace while spending was rising by 5.2 percent. Revenues that rise twice as fast as outlays will obviously narrow the budget gap if economic growth is permitted to continue. Interest payments are up about 20 percent, however, because the Fed decided to hike interest rates by 20 percent. Other federal spending is up only 2.5 percent, a decrease in real terms, while "real" tax revenues are rising by 7-8 percent. In 1980, by contrast, real federal revenues fell by 1 percent while real, noninterest outlays rose by 3.6 percent. Compared with Carter-Mondale "bracket creep," the Laffer Curve is doing very well.

Postponing effective tax cuts until 1983 was merely a disaster. The monetary version of demand-side "Reaganomics" turned out to be much worse. The monetarist goals in the Administration's 1981 Agenda were 7.5 percent annual growth of the "M_1" money supply in 1981-82; the Fed delivered 6.9 percent. Despite later complaints about the monthly wiggles in M_1, Administration monetarists really got what they asked for when they asked for it. Treasury Undersecretary Beryl Sprinkel publicly complained about supposedly excessive M_1 growth on May 4, 1981 and January 22, 1982; the Fed responded by tightening the cost and availability of bank reserves at its meetings of May 18 and February 1. That kept the critical fed funds rate at 14-19 percent from May 1981 through July 1982.

The combination of excessively tight money and postponed tax relief was supposed to slow the annual growth rate of nominal GNP *gradually* to something like 10 percent. Instead, nominal GNP rose at a meager *2.8 percent* rate from the third quarter of 1981 through the end of 1982, though "M_1" was rising at an annual rate of 7.4 percent. This could not have happened within the monetarist framework, although it did.

Who forecast what?

Supply-side criticism of Federal Reserve overkill in 1982 is not mere hindsight. In *The New York Times* of June 26, 1981, before the passage of the tax bill, Jude Wanniski warned of the burden of monetarism on the Reagan strategy. "Inflation is to be whipped with a world-wide going-out-of-business sale," he wrote; "austerity is just around the corner for the GOP." On July 23, 1981, economist Gene Birnbaum likewise observed in *The Wall Street Journal* that a two-month bulge in M_1 had prompted the Fed to raise "the fed funds rate back toward the 19 percent-plus area." Birnbaum rightly worried that "a combination of such exceptionally high real interest rates and a strong dollar . . . may ultimately crush the economy."

Robert Mundell, at a conference in Italy in April 1981, also worried that "the United States will clamp down . . . in a squeeze that ends in widespread bankruptcy." He proposed instead to stabilize the dollar value of international gold reserves by easing Fed policy if gold slipped below $400 and tightening around $450. Mundell was joined in this general proposal by Jelle Zijlstra, head of the Bank of International Settlements, in Zijlstra's September 27 plea to the IMF to "consider ways to regulate the price of gold."

People around the world really *did* believe that this Administration would drive inflation down, and that belief made it safer to hoard more dollars. Indeed, the dollar rose and commodity prices fell from the moment of Reagan's election. In my Gold Commission testimony of November 13, 1981, I cautioned that such a sudden rise in the global *demand* for dollars "could produce an abrupt deflation, with widespread bankruptcies as prices fell faster than contracted costs."

The Fed could not literally "control" the M_1 money stock, which might rise because of deflation-related

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demand for cash or inflationary Fed supply. All the Fed could do was to react to an observed spurt in currency and bank deposits by raising the interest rate on bank reserves. Bouncing the "fed funds" rate up and down to chase "M_1" often made cash more attractive than bonds, creating new risks for long-term investments due to sudden swings in bond prices. Paul Evans of Stanford estimates that this instability alone raised long-term interest rates even more, and reduced real GNP "by about 1 percent in 1980 and by about 2.5 percent in 1981 and 1982."

On June 29, 1982, I surveyed the monetary wreckage in the *Journal*: "A large and vital segment of the dollar economy, worldwide, is suffering severe deflation. Prices of industrial commodities have fallen every month since August, at nearly a 25 percent annual rate. Those who turn out primary products see their selling prices go down while interest rates stay up. That cost-price squeeze requires more borrowing to pay the bills, but the rising real burden of the debt leads to layoffs, plant closings and bankruptcies."

Table 1. **Average Federal Tax Rates (percent)**

	1970s	1980	1981	1982	1983	1984[a]
Personal income	12.8	14.1	14.5	14.1	12.9	12.4
Social Security	11.5	12.8	13.7	13.7	14.1	14.6
Corporate	39.3	40.1	34.6	29.3	26.6	26.7
Total revenue as % of GNP	19.4	20.6	21.1	20.1	19.4	19.3

Source: Congressional Budget Office.

[a]Estimate.

A month later, also in the *Journal*, monetarist Allan Meltzer wrote that "if the Federal Reserve returns to high monetary growth, long-term interest rates will rise." But the Fed could no longer afford to listen to that paralyzing theory—it instead began to meet the soaring global demand for dollars, ignoring M_1. Contrary to the monetarist expectation, long-term interest rates fell like a stone.

The years 1981 and 1982 provided no test of either the tax or monetary proposals of supply-side economists. Tax rates were *not* reduced in those years, but were instead increased. Commodity prices and exchange rates were *not* stabilized, but were instead destabilized. What we experienced in 1981-82 was a massive failure of demand-side economics—a failure so glaring that the supply-side challenge became an unbearable embarrassment. Budget deficits were *supposed* to be inflationary, yet prices fell. The modest slowdown in the money supply was *supposed* to generate an equally modest slowdown in "aggregate demand," yet GNP collapsed.

The supply-siders, who had warned about all this from June 1981 to June 1982, were continually dismissed as too gloomy. In October 1982, when Polyconomics predicted that a normal 6-7 percent recovery would begin in the first quarter of 1983, the supply-siders were then dismissed as wildly optimistic. On January 4, 1984, we made another controversial forecast of noninflationary 6.5 percent real growth in the *Journal* editorial "Voodoo's Revenge"—a forecast that finally became the "consensus" view seven months later. The demand-side fiscalists were again surprised, with Larry Kudlow first expecting "crowding out" and stagflation by mid-1984, then adroitly explaining that deficits had instead "stimulated" the real economy.

Although the record was by this time clear on who had forecast what, supply-side adversaries were struggling to withhold credit and shift blame. Tom Redburn of *The Los Angeles Times* wrote on January 27, 1984 that "until recently, supply-side boosters mostly had been licking their wounds, arguing among themselves over why the economic boom they had forecast had failed to materialize." Yet *no* supply-sider had forecast a "boom" from the tax increases and absurdly tight money of 1981-82. Supply-siders were the only ones who warned of the consequences. The Administration's monetarists and Keynesians had instead forecast a brisk recovery in *early 1982*, because previous M_1 growth and reduced tax withholding were supposed to stimulate "consumer demand."

One monetarist, Morgan Reynolds of Texas A&M, wrote that "the supply-siders' inattention to monetary theory has damaged their political influence since their predictions have been falsified by events." Yet consider the predictions of another prominent monetarist, Milton Friedman. In a letter to *The Wall Street Journal* on June 28, 1982, Friedman worried that money growth was "dangerously high." By August 23, in his *Newsweek* column, the 1982 recovery that he had predicted had been "aborted by a drastic cut in money growth." In an October 25 interview with *Barron's*

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that drastic cut had become an inflationary "monetary explosion." A year later, on September 1, 1983, Friedman's "Why a Surge of Inflation Is Likely Next Year" appeared in the *Journal*. That was quickly followed by "A Recession Warning" in his *Newsweek* column of January 18, 1984. By April 3, 1984, Friedman was back to telling *The New York Times* that "we shall be fortunate indeed if prices are not rising in the 7-10 percent range by the fourth quarter of the year." Professor Friedman's single-variable money supply model was obviously unable to cope with the unfolding economy.

A "credit" expansion

In 1983, both Keynesians and monetarists scrambled to take credit for a noninflationary investment boom that they did not predict, which was based on policies they emphatically repudiated. Those who were surprised by both the recession and the recovery suddenly argued that nothing surprising had happened. Journalists began the amusing sport of blaming the recession on tax cuts and giving the Federal Reserve full credit for the recovery. The Fed estimated that industrial capacity rose by less in the recovery than in the recession, and proceeded to worry that we were running out of capacity by producing so many machines.

In a mid-1984 MacNeil-Lehrer debate with Jack Kemp, Charles Schultze saw "absolutely no evidence" that all this investment had added any capacity. The new Brookings Institution theory is that we had achieved more output with no more inputs—there was no more incentive to invest or work, just more investment and more workers. The demand-side economists tried to explain the U.S. recovery with one or another of their single-variable models—the budget deficit or money supply. But if real growth really depended on the supply of such government IOUs, then the recovery would have been sooner and stronger in other countries. Belgium and Italy, for example, had budget deficits of 12-14 percent of GNP, but Italy's economy stagnated and Belgium had modest growth. In the first quarter of 1983, when the U.S. recovery began, the "M_1" money supply was up 9 percent from a year earlier, compared with 9.9 percent in West Germany and 17.5 percent in Switzerland, yet real GNP did not rise in either Germany or Switzerland in 1983.

Keynesians shamelessly declared that this was their own "consumer-led" recovery. In the *Times* of July 8, 1984, Samuel Bowles claimed that "the big boost is from expanded . . . military spending." Table 2 shows that the big boost was instead from business investment, housing, and consumer durables. Real government purchases actually fell, and true consumption (services and nondurables) was quite weak. Exports staged a good recovery, despite poverty in the developing countries, and imports in 1983 were only 7.5 percent of GNP—down from 9.2 percent in the weak-dollar years of 1979-80. In the first half of 1984, business investment sped up to a 20 percent rate of increase, and real GNP growth averaged a marvelous 8 percent between the second quarters of 1983 and 1984. Far from being an inflationary boom, as the monetarists predicted, or a Keynesian consumer boom, the Reagan expansion has been an investment boom of unprecedented proportions.

Table 2. **First Year of Recoveries**
(percent change in real outlays over four quarters)

	1983	Previous 3 recoveries	All postwar recoveries
Business fixed investment	14.2	3.7	7.8
Housing	41.6	22.6	20.0
Personal consumption	5.7	5.0	5.4
less durables	3.7	NA	NA
Exports	3.1	−0.2	3.7
Government purchases	−4.1	0.3	2.1

Sources: U.S. Department of Commerce, Federal Reserve Bank of St. Louis, I.R.E.T.

How could investment flourish despite abundant unused capacity in 1983 and the Federal Reserve's outspoken efforts to slow the progress with interest rates that were four times the rate of inflation? The only coherent answer is that the after-tax reward for investing was so attractive that it justified borrowing at such high real interest rates. Accelerated depreciation and the investment tax credit are obvious reasons, but lower marginal tax rates on "personal" income also raised the net return for unincorporated business and for individuals' dividends and capital gains. Clearly, reduced marginal tax rates on capital *did* induce more investment, and reduced tax rates on labor were favorable to both investment and employment.

Labor productivity had risen by 0.6 percent a year

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for nine years, but now rose at a 3.3 percent annual rate from mid-1982 to mid-1984. And this was no Thatcherite trick of raising productivity by keeping output unchanged and firing workers. The combination of employment *and* productivity growth was without precedent. Wage gains remained surprisingly moderate, unit labor costs fell, and real wages rose.

What if there had been no Reagan tax cuts? Allen Sinai, using the Data Resources econometric model, estimates that real GNP would have fallen by 1.3 percentage points more than it did in the Fed's 1982 credit crunch. He also calculates that the 1983 recovery would have been 1.2 percentage points slower. That translates into a $180 billion loss in *real* GNP—half of which, he estimates, would have been in business fixed investment. Business and personal saving would have been reduced by $167 billion in 1984 alone, about $50 billion more than combined federal, state, and local deficits.

Supply-side and its caricatures

As Leonard Silk correctly reported in *The New York Times* on July 27, 1984, supply-side economics goes back to at least 1971, when Columbia's Professor Robert Mundell advocated reducing marginal tax rates to encourage added production, while stopping inflation by stabilizing the value of the dollar in terms of gold. This "Mundell mix" was offered as an alternative to President Ford's tax surcharge plan in Jude Wanniski's seminal article "It's Time to Cut Taxes" in *The Wall Street Journal* of December 11, 1974.

Wanniski reported that Mundell "would adjust income tax brackets across the board and index them . . . If taxes are not cut now, the size of the unemployed sub-economy will expand. Tax revenues of state, local and federal governments will decline. At the same time their outlays for unemployment relief and welfare will expand. Combined government deficits might even exceed the amount implied by a tax cut . . . With lower taxes, it is more attractive to invest and more attractive to work; demand is increased but so is supply."

"The dollar would appreciate against foreign currencies," Wanniski continued, and "dollar holders will have a higher incentive to invest in capital goods. . . . Capital that is now flowing out will remain; foreign capital going elsewhere would come in. The increased real economic growth would mean the U.S. would run a sizable trade deficit. . . . The expectation of slower inflation would cause a reduction in optimal inventory levels." *Nine years before his policies were tried, Mundell had accurately predicted their effects.*

Those who were surprised by the outcome of Mundell's advice have attempted to deny that the U.S. economy in 1983-84 has, in fact, performed better than it had in decades. In the *Times* of January 15, 1984, Michael Harrington wrote that "the Reagan supply-side strategy failed: production did not turn upward, because the rich and the corporations did not invest the enormous tax subsidies." An equal reduction in tax rates is considered "unfair," in this view, because those who pay no taxes receive no *direct* benefit from a tax cut. What was actually unfair was that the 50 percent maximum tax has not yet been reduced at all. The top 1 percent of all taxpayers paid 7.5 percent of all income tax in 1978, 8.5 percent in 1980, and 9 percent in 1982. The recession did, of course, cause poverty, but a study by Richard Nathan of Princeton finds the 1981 budget cuts had "much less of an impact on services than people believed." [See "The Budget Cuts: The Day After" by Richard P. Nathan and Fred C. Doolittle, *Challenge*, January/February 1984.]

Supply-siders have grown accustomed to being criticized for positions they never held and predictions they never made. Barry Bosworth recently managed to write a whole book *(Tax Incentives and Economic Growth*, Brookings, 1984) about supply-side economics without quoting a single supply-sider, offering only a footnote for one supply-side fiscalist (Ture). Bosworth's caricature says supply-siders assume continuous full employment, and he regards the recession of 1981-82 as a "period of seemingly ideal circumstances in which to observe a rise in private savings rates." His selective "review of research has been encouraging because it suggests that the incentive effects are not as large as some of the recent public discussions would have one believe." In a footnote, he correctly notes that "the recession cannot be blamed on the fiscal program proposed by the administration. It was planned by the monetary authorities . . ."

Bosworth leans rather heavily on an old fallacy, claiming that the "income effect" of tax cuts could be a *dis*incentive to produce. That is, people will be so much wealthier because of a tax cut that they may work and invest less than before. But if everyone produces less they will be poorer, not richer, which (according to

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Bosworth's theory) should make them work harder. Poverty is what creates wealth in the Bosworth model. Yet the theory of tax incentives is not really ambiguous or paradoxical, as has been rigorously explained by James Gwartney and other supply-siders whom Bosworth chooses to ignore.

It is particularly ironic that supply-side economics is so often judged by Bosworth and others according to the so-called "personal savings rate." The savings rate is the Keynesian "marginal propensity to save," relabeled as supply-side by the Cambridge zero-sum theorists, Martin Feldstein and Lester Thurow. "Real supply-side economics," advised Thurow, "would require Americans to endure a 5- to 10-year period during which consumption and the standard of living must fall in order to make room for investment." Many business managers parroted this idea, arguing that people—even managers—were irrelevant to economic progress.

In genuine supply-side analysis, people only produce in order to consume, or to acquire assets that will let them consume later. A tax system should not be biased against either present or future consumption, since both are incentives to produce. By improving the incentives and dynamic efficiency of economic policy, supply-side economics intends to raise the quantity and quality of goods and services over time of "potential GNP." In that case, both savings *and* consumption would rise.

Table 3. **Measurements of Savings (in percent)**

Year, quarter	Commerce Dept. savings rate	Federal Reserve savings rate
1983 II	4.2	8.9
III	5.0	9.1
IV	5.3	10.5
1984 I	6.1	11.1

The percentage of current "personal" income that is not "consumed" would be a particularly perverse supply-side goal. Reducing personal income with a big tax increase would probably *raise* the "savings rate." In the taxflation of 1974 the savings rate soared to 8.5 percent, as income and wealth contracted, yet the real value of current and past savings fell.

Within these Keynesian accounting categories, however, even *personal* savings remains understated because of "the treatment of purchases of consumer durables as consumption instead of saving [and] the treatment of government life insurance and retirement funds as taxes instead of saving." (Patric Hendershott and Joe Peck, "Household Saving: An Econometric Investigation," NBER Working Paper No. 1,383, June 1984.) These adjustments are included in the Federal Reserve's flow-of-funds measurement of "personal" savings, with results as shown in Table 3.

Savings is an increase in wealth, and the booming stock and bond markets of 1982-83 raised real wealth by at least a trillion dollars. Paper claims against future production became more valuable with expanded opportunities for profitable production. The enormous increase in reinvested corporate profits should also be considered "personal" savings—people own the corporations. Combined corporate and personal savings (even without the Federal Reserve adjustments) rose by 22 percent in the first five quarters of recovery, from 16.9 to 18.1 percent of GNP. At the same time, combined government deficits fell from 33 to 17 percent of private savings.

Attacks by monetarists and libertarians

Criticism of supply-side policies from conservative and libertarian scholars does not recognize that the supply-side economic expansion has also contributed to their own agenda—negligible inflation and reduced growth of government spending. Murray Rothbard says that "the supply-siders care not at all for the deficit or for the level of government spending." Thomas Hazlett writes that the "Soviet Union is the quintessential supply-side economy" and that "implicit in all supply-side prescriptions is a positive view of government spending." Leland Yeager decries "today's tacit alliance between big spenders and supply-side inflationists . . . We who are more libertarian," he suggests, should "ponder the idea of strictly temporary tax increases." Karl Brunner writes that supply-siders "claim that inflation can be overcome at little or no social cost by a *massive* monetary expansion." Yeager suggests that supply-siders have "caricatured monetarism unfairly," though he has written in *Policy Review* (Winter 1983) that "Reynolds is right in asking us to look beyond monetarist prescriptions."

Supply-side advocates of a commodity standard or

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stable exchange rates are not "inflationists" because they complain about *falling* commodity prices or an ever-rising dollar. We would be inflationists only if we did not also advocate monetary tightening whenever the dollar collapsed and the price of gold soared, as has occurred only under monetarist schemes.

Yeager believes it is "grossly irresponsible" for supply-siders to question the mismeasurement of deficits, or to ask for evidence that deficits necessarily raise either interest rates or inflation. The burden of proof, however, is on Yeager. An exhaustive survey of two dozen studies trying to link budget deficits and interest rates, in the CBO's February 1984 "Economic Outlook," found no credible evidence of any significant effect. Even our Keynesian critics, like Alan Blinder, likewise find no evidence that the Fed typically creates excess money to finance deficits. It is not that deficits "don't matter," but that deficits of the magnitude recently experienced are less damaging than trying to squeeze equivalent taxes out of one year's output.

Any ill effects from government (or private) borrowing depend on the methods of finance and *the specific alternatives* being proposed. Government spending *is* the average burden of government, but the *marginal* burden on new production depends on specific timing and methods of taxation. The reason for cutting federal spending is also the reason for cutting marginal tax rates—both changes free up resources for uses the market prefers, and both improve incentives for production and exchange. A deficit does imply that tax revenues must be higher in the future to service the added debt, but a larger economy can generate that added revenue at lower tax rates.

The supply side of Reaganomics has been so successful that the demand-siders have repeatedly urged higher tax rates and higher interest rates to slow the allegedly "overheated" recovery. It must always be remembered that such advice comes from the same economists who were responsible for the policies of 1968-82. Monetarism, in particular, is the main casualty of 1981-82 and must be fundamentally reconsidered. The experience of 1983-84 shows what invigorated enterprise can accomplish with modest encouragement. The United States should press forward with lower marginal tax rates on a broad and growing tax base, further liberalization of trade and regulations, and a long-term guarantee of the dollar's value in gold.

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