Why the supply-side strategy will fail

By Fred Harrison

THE SUPPLY-SIDE economics of President Reagan and Prime Minister Margaret Thatcher has left two countries in a mess.

The contradictions in an incomplete policy have steered the United States and Britain into the deepest recession since the 1930s. And there is little evidence that the policy-makers are aware of what direction to take now.

At the heart of the economic strategy of the New Right that emerged in the late 1970s was a monetary approach to the solution of long-standing economic problems.

> **A tight control of the money supply, allied with tax cuts and reduced government spending, was supposed to boost investment, create new jobs, slash the rate of inflation and establish a new foundation for sustained economic growth.**

Instead, interest rates have soared to record levels and unemployment in the OECD (industrialised) countries is now around 30m. **In America,** where President Reagan was elected on the promise to balance the budget, the nation's deficit is now forecast to exceed $100 bn.

And his promise to cut taxes is now overtaken by the need to raise taxes in a desperate attempt to cut government borrowing.

In Britain, Margaret Thatcher's main policy objective was to cut the rate of inflation; and she now insists, as the unemployment rate topped 3m. in January, that she must not be side-tracked from this objective. But there are no signs of success for the main plank of the Conservative strategy. The facts are provided in the table that gives the UK tax and prices index.

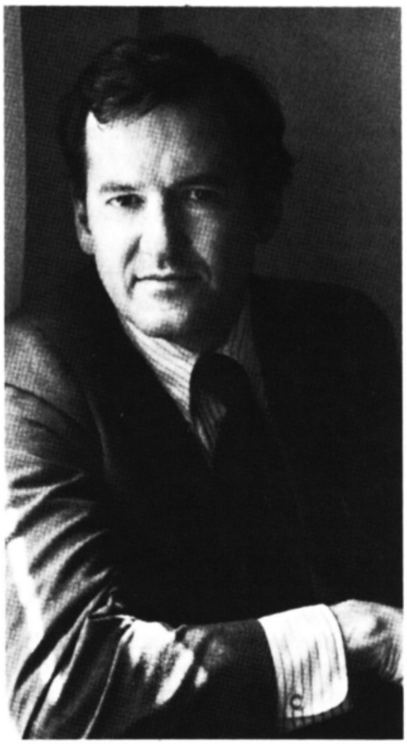

Photo: Rhoda Nathans

● **George Gilder**

When she came to power in 1979, Mrs. Thatcher decided to change the basis on which inflation would be measured. For there was evidence that, if taxation policy was taken into account, **this** index of inflation was slowing down markedly over the period 1977/1978 compared with the usual retail prices index.

Because Mrs. Thatcher was determined to cut taxes further, she decided that – for propaganda purposes – emphasis should be placed on a new tax and price index.

Well, although Chancellor of the Exchequer Sir Geoffrey Howe did cut taxes at the first opportunity, the government's strategy rebounded on itself. And after two years of Thatcher-style monetarism, the tax and price index is rising **faster** than the conventional retail prices index!

THE Retail Price Index measures changes in retail prices only and is therefore a less comprehensive index than the Tax and Price Index. The TPI measures the increase in gross taxable income needed to compensate taxpayers for any increase in retail prices, and takes account of the changes to direct taxes (including employees' national insurance contributions).

UK TAX AND PRICE INDEX

	1974	1975	1976	1977	1978	1979	1980	1981
	61.2	79.2	92.4	99.3	104.3	119.8	139.4	161.2
Percentage changes on one year earlier								
Tax and price index		+29.4	+16.7	+7.5	+5.0	+14.9	+16.4	+15.6
Retail prices index		+24.9	+15.1	+12.1	+8.4	+17.2	+15.1	+12.0

January 1978 = 100. Data for December each year. Source: Central Statistical Office

TO WHAT DO we attribute the apparent failure of the monetarist strategy?

President Reagan blames high interest rates, the 5% slump in output and a rise in unemployment to nearly 9% on Federal Reserve policy.

The White House claims that the Fed has pursued an unduly **tight** monetary policy.

But Prof. Milton Friedman, the architect of policy based on monetary theory, blames the British recession on the **loose** and delayed application of monetary policy.

"If Mrs. Thatcher had taken the medicine from the beginning, there wouldn't have been 3m unemployed," Prof. Friedman told the West German magazine *Der Spiegel* in January.

Whichever way we look at it, then, it seems that tight and loose monetary policy, under present conditions, yields identically depressing results. Should we be surprised?

THE CENTRAL deficiency in the current approach to monetary and fiscal policy is that it neglects a crucial variable: land.

On the face of it, supply side economics *ought* to work. By cutting taxes, corporations and consumers are left with larger net incomes with which to buy more capital and durable goods. The overall result *ought* to be accelerated economic growth.

But by failing to neutralise the speculative effect, the opportunities presented by a reduction in tax levels are destroyed before they have a chance to germinate.

The evidence for this proposition can be examined in the context of the Kennedy tax cuts which were implemented in the mid-'60s.

The Kennedy tax cut is now cited as the principal piece of empirical evidence in support of the supply side economics of the Reagan Administration,[1] and it therefore also offers us a fair opportunity for predicting the outcome of the present efforts in Washington.

THE MAXIMUM tax rate in 1963 was 91%. This was reduced to 77% in 1964 and 70% in 1965.

There was a momentary upturn in corporate profits, and according to Reagan's theory this should have lifted the economy to a new plane of activity.

George Gilder's current best-seller *Wealth and Poverty*, which can be represented as the bible for the exponents of Reaganomics, argues that the Kennedy tax cuts "brought almost surgically beneficial effects to the economy."[2]

Larger post-tax profits meant an increase in investment and a faster rate of economic growth. This proposition has now been challenged by Peter Drucker.[3]

THE KENNEDY TAX EFFECT

	Maximum tax rate: per cent	Increase in US land values: $bn
1962	91	31.754
1963	91	24.103
1964	77	30.491
1965	70	35.803
1966	70	44.043

He has pointed out that the Federal tax cuts prove nothing, for there was a simultaneous sharp increase in state and local taxes. This offsetting increase effectively neutralised the stimulative impact on the demand side of the economy.

But Drucker's criticism is oversimplified.

Most of the money raised in increased local and state taxes was from low and average wage earners. Because their propensity to consume was high, Drucker is correct in arguing that there was no significant jump in retail sales as a result of the Kennedy tax cuts. Thus, there was no "demand pull" effect on economic growth.

High income earners, on the other hand, were not seriously affected by the non-federal tax increases. And their propensity was to save. So their post-tax incomes were significantly higher, and practically all of that extra income was invested.

This should have had a "push effect" on the growth of the US economy. And as it happens, Reagonomics emphasises the prospect of increased demand arising from an increase in the supply of goods. Supply creates its own demand, the theory known as Say's Law.

What happened in the mid-'60s?

Gilder stresses the fact that the cut in tax rates caused a shift in the pattern of investment: *more money went into businesses, and less into real estate.*

It was this transformation in the portfolio of asset holders that caused the beneficial effects on the economy, in Gilder's view.

Gilder, unfortunately, had forgotten his reading of Henry George's *Progress and Poverty*,[4] which he identified as "one of the great inspirational works of economic literature."

The prospects of making speculative gains were still present; for the tax cuts were not simultaneously offset by an increase in the tax on land values.

On the basis of Ricardo's theory of rent we can predict that the land monopolist will exact the first claim on an increase in post-tax incomes. *And that is what happened in the US following the Kennedy tax cuts.*

In each of the five years up to 1964, land values increased by between $24 bn and $30 bn. In 1965, the increase leapt to $35 bn, and the decade's peak was in 1966 ($44 bn).

The benefits of the tax cuts were mopped up by the land monopolists through an increase in the capitalisation of land. The inevitable happened. The economy slipped into a recession in the last quarter of 1966.

WE CAN NOW appreciate the real reasons behind President Reagan's complaint that industry is not responding to his initial tax cuts.

The capacity for expansion is undermined by the drag of rents and land prices that are too high for the current level of wealth-creating activity.

Consumption is being held down, so entrepreneurs cannot respond to rising demand; and the prohibitive cost of buying or renting land on which to set up new businesses is curtailing the supply of new goods and services.

The result is the current economic crisis and confusion of policies on both sides of the Atlantic.

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Aussies strike foreign speculators

AUSTRALIA is clamping down on foreigners who are speculating in the continent's mineral resources and farmland, *writes Ian Barron.*

The government's watchdog, the Foreign Investment Review Board, is tightening up regulations.

In future, speculators will have to show that there is a net economic benefit before foreigners can buy rural land.

Purchasers will have to prove that new techniques or developments will be introduced which will benefit Australia.

These moves will affect British and US institutions like pension funds, which are the biggest buyers of rural land.

The number of proposals approved by the Board last year more than doubled. They involved over 100 properties.

These changes in the rules are supposed to discourage absentee landlords and speculators from abroad. Rural organisations in Australia have argued that absentee landlords and speculators

- **push up land prices;**
- **allow properties to deteriorate; and**
- **reap windfall profits from the re-zoning of rural land for urban use.**

There is no evidence, however, to show that the authorities are concerned about similar effects being generated by Australian speculators and absentee landlords.

But the Cabinet has decided that, in future, there should be greater Australian equity participation in the mineral processing industries.