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SUPPLY-SIDE ECONOMICS: ITS ROLE IN CURING INFLATION

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SUPPLY-SIDE ECONOMICS: ITS ROLE IN CURING INFLATION

During the past several years, a profound revolution has been occurring in the thinking of many of our nation's leaders concerning the proper role of fiscal policy in helping to maintain the health of our economy. For more than 30 years, our government tried to use fiscal policy as a means of smoothing out fluctuations in business activity. Tax rates were cut, and expenditures increased, when recessionary forces were pervasive. Growth in expenditures was restrained--and on one occasion, tax rates were increased--to cool off inflation.

Deep disillusionment has set in regarding the results of those efforts. As the prestigious Joint Economic Committee stated in its recent mid-year Report on the economy, a review of the postwar period shows that "government attempts to shorten the duration or reduce the intensity of recessions. . . have been ineffective." Economic policy for the future, the JEC argues, "must focus on the supply side of the economy, on the long-term capacity to produce. . . ."

Supply-side economics is an exciting doctrine. Its central tenets are not entirely new, but they certainly are relevant. Our principal economic problem today is inflation. A long-term strategy is needed to deal with it.

Supply-side economics in fiscal policy is a logical complement to the way in which monetary policy is currently being conducted. Last October, the Federal Reserve announced that it was changing its methods of implementing monetary policy in ways that would improve its control over the expansion of money and credit. Under this new monetary policy strategy, prospects have been enhanced that growth of money and credit will slow over the long-run to rates that are consistent with a moderation of inflation, and eventually a restoration of price stability. If fiscal and monetary policies both aim at reducing inflation over the long run, the prospects for success in this effort will surely be greater.

How much help can we really expect from supply-side economics in curing inflation? As I think about that question, I cannot help but remember the enthusiasm with which economists of my generation embraced the old fiscal doctrines 30 years ago. We spent a large part of our energy elaborating the theory of aggregate demand management, as it was so often called, and testing its conclusions against the facts. We tried our best to make fiscal policy work in ways that would reduce unemployment and idle capacity, keep the economy operating close to its full-employment potential, and yet avoid periods of excess demand that create fresh inflationary forces.

In retrospect, our principal mistake was a failure to recognize the severe limitations of aggregate demand management in an economy as complex as our. We tried to achieve results that simply could not be realized.

The same danger exists now, I believe, with supply-side economics. Steps to increase the potential output of our economy and to improve productivity can make a vital contribution to dealing with inflation. However, unless we recognize the limits of supply-side economics, and design our economic policies accordingly, we could end up making our inflation problem worse instead of better.

What do we mean by supply-side economics? Conceivably, a wide range of things could be included--energy policy, manpower training, Federal support for higher education, and other programs that might increase the growth of supply or enhance productivity. I propose to focus today on three principal areas in which public discussion of supply-side economics has centered in the past several years: first, tax reductions on earned income--that is, on wages and salaries--to increase incentives to work; second, tax incentives to businesses to increase the rate of capital formation and thereby to improve productivity; and third, tax reductions on investment income to encourage a larger volume of private savings.

In discussing these three ways to increase aggregate supply, I do not propose to break any new ground. My objective is merely to make some common sense observations on the potential contribution of this fiscal policy approach to solving our inflation problem.

Tax Reductions on Earned Income

Tax reductions for wage and salary income, if they contributed to the fight against inflation, would certainly have the enthusiastic support of a large number of our citizens. The average American gives up about one-fifth of his income in the form of direct tax payments to government; upper-bracket rates are, of course, much higher--up to 70 percent for the Federal personal income tax. Reducing these tax rates significantly might increase the willingness of individuals to work, and it could do so in a variety of ways--by increasing hours worked per day or per week, inducing larger numbers of women to enter the labor force, encouraging postponements of retirement age, or making people willing to work harder. Is it possible that the aggregate supply of labor, and hence the output of goods and services, would rise substantially as a consequence of such tax reductions?

A bit of thought and introspection should raise some doubts in our minds. Work hours tend to be set by institutional arrangements as much as by individual decisions. Objectives for working, moreover, are complex and varied; many of us work for reasons other than simply the income we earn. Moreover, it is difficult to predict whether a completely rational economic man would work more or less if taxes were lowered. Lower rates of taxation increase the take-home pay that can be earned from an additional hour of work or a second job, but they also make it possible to attain any given standard of living with less work.

Studies of the effects of taxation on the available supply of labor both in the United States and in other countries are numerous, but their conclusions are ambiguous. Even in countries where tax rates are considerably higher than in the United States, such as the United Kingdom, it is not clear that labor supply would increase if taxes were lower. In a summary of the available evidence two years ago, the Congressional Budget Office concluded that labor supply probably would increase if taxes on earned income in our country were reduced. The effect, however, would be small; total hours worked might increase by perhaps 1 to 3 percent for each 10 percent rise in after-tax wages.

Reductions in taxes on wages and salaries stimulate demand as well as supply. Estimates of the increase in demand that would result from such tax reductions are also controversial. Nonetheless, the available evidence indicates that the increase in aggregate demand would be substantially larger than the increase in aggregate supply, possibly 5 or 10 times as large, or maybe more.

Tax reductions on wage and salary incomes, therefore, are not the most promising way to cure inflation. Indeed, unless the effects on aggregate demand were neutralized by raising other taxes or cutting budgetary expenditures, such tax reductions--if undertaken on any substantial scale--could make our inflation problem worse.

This does not mean that our government should be insensitive to the burden of taxation that Americans are bearing. Certainly, our chances for healthy economic growth will be greatly enhanced if the share of our national resources devoted to Federal uses is reduced and the rate of taxation is lowered. But it does suggest that the principal contribution that supply-side economics can make to fighting inflation lies elsewhere.

Investment Incentives and Productivity

Providing tax incentives for business investment is another form of supply-side economics, one that we know more about. On several previous occasions during the postwar period, incentives to business capital formation have been increased through accelerated depreciation, or an investment tax credit, or a reduction in corporate profits tax rates. We therefore have some basis on which to judge their efficacy in stimulating capital formation and productivity growth.

A number of proposals have been put forward recently to stimulate investment through tax incentives. For example, in the Administration's recently announced fiscal program, allowable depreciation rates for new plant and equipment would be increased by 40 percent, and the investment tax credit would be liberalized somewhat. The cost of these incentives, in terms of loss of Federal revenues, would initially be small but would reach \$25 billion per year by fiscal 1985. Corporate tax payments in that fiscal year would be reduced by approximately 17 percent as a result of the new tax incentives.

It has been estimated that these investment incentives would increase the long-term growth rate of productivity in our economy by about 0.4 percent per year--not right away, but after several years. Judging by studies of the effects of investment incentives introduced in the past, this is a fairly

generous estimate, but a reasonable one. To put this amount of improvement in perspective, we might note that productivity in the past five years has been rising on average at about 1 to 1-1/2 percent a year. With an improvement of 0.4 percent, the trend would be up to 1-1/2 to 2 percent. If improvements in productivity growth occurred for other reasons as well, we might hope to regain the 2-1/2 percent average annual rise that characterized the first two decades of the postwar period. To put it another way, an improvement of 0.4 percent in annual productivity growth would lead, over the course of a generation, to an increase of 10-1/2 percent in the potential output of our economy. Such an increase would make possible a welcome improvement in standards of living, in addition to its potential contribution to moderating inflation.

Tax Incentives to Increase Savings

Increased investment expenditures, however, must be financed by increased savings. Otherwise, they, too, may add to inflation rather than reduce it. Let me turn next, therefore, to the third area of supply-side economics that I mentioned earlier: are reductions in taxes on investment income an effective way to increase savings?

Unfortunately, in this area, too, we do not know as much as we need to know to justify bold action. Like reductions in taxes on earned income, tax reductions on investment income cut two ways. By raising the after-tax earning power of every dollar saved, they increase the benefit to the consumer of postponing purchases today in order to increase buying power tomorrow. But because of that, they reduce the amount that a consumer has to save to assure his ability to achieve a given living standard later on.

No one knows for sure which edge of the blade cuts more deeply. Some studies have concluded that if our tax structure were changed in ways that reduced the taxation of investment income, and raised the level of taxes on other forms of income, there would be no effect at all on private saving. Others suggest beneficial effects on private saving. This state of affairs should not prevent us from experimenting cautiously with changes in the tax structure that might encourage more saving. In light of the uncertainties, however, it is hard to imagine that tax incentives to foster savings can play more than a minor role in our battle against inflation, at least in the relatively near future.

Fortunately, there is a surer way of increasing the amount of savings available to finance a higher rate of business investment. It is an old-fashioned method, and one that has not been used much in the past two decades. It is to reduce the deficit in the Federal budget through restraint on Federal spending as rapidly as economic conditions warrant, and eventually eliminate it altogether. Surpluses in the Federal budget, used to retire debt, would return funds to financial markets that could finance the additional business investment needed to improve productivity growth. That is also the way to increase the prospects that improved productivity growth will actually result in lower inflation. Let me turn to that issue next.

Productivity and Inflation

Increasing productivity growth through tax incentives for business investment appears to me to be the most promising route for moderating inflation through supply-side economics. But will it work? And how well?

Unfortunately, there is no guarantee that improved productivity will automatically reduce inflation. Indeed, among the major industrial nations of the world, rates of inflation during recent years have not been closely correlated with rates of productivity increase. From 1974 to 1979, for example, manufacturing productivity rose faster in France than in any other major industrial country. Yet, the rate of inflation in France during that period was higher than that for the U.S. and Canada, and far above that for Japan and West Germany.

How much an improvement in productivity contributes to reducing inflation depends on the responses of businesses and workers. If businesses do not, or cannot, increase their profit margins, the slower rise in costs that higher productivity brings will show up in smaller increases in prices. If workers then accept smaller wage increases because inflation is moderating, costs would rise still more slowly and the inflation rate would come down further. The inflation rate might ultimately decline by two to three times as much as the initial increase in productivity.

The potential reduction in inflation made possible by a higher rate of advance in productivity will be realized, however, only if conditions in labor and product markets promote the necessary response in wages and prices. Product markets must be sufficiently competitive so that businesses are motivated to pass reductions in their costs through to lower prices. Markets for labor must be sufficiently slack so that workers are encouraged to accept smaller wage rate increases as the rise in prices moderates. That is why prudent monetary and budgetary policies--policies that aim for slower growth of money and credit and for movements of the Federal budget toward surplus--are a necessary adjunct to supply-side economics. Unless these two work hand-in-hand, the promise that supply-side economics holds for reducing inflation could easily be lost.

Let me try to pull the threads of my argument together. Tax incentives to stimulate business capital spending appear to be the surest way of increasing our aggregate capacity to produce. At a cost of about \$25 billion annually by 1985, in terms of revenue loss to the Treasury, we might reasonably expect productivity growth to increase by about 0.4 percent per year. Under favorable economic conditions, the inflation rate might be brought down by about 1 percentage point or perhaps a little more, through this means. These are, I believe, realistic estimates of the costs and benefits of going the route of supply-side economics.

If the cost is that high, you may ask, is it worth it? I would respond: What better alternatives are there? Certainly, it is preferable to use tax policy to increase productivity and our capacity to produce than to try to squeeze out inflation by relying solely on highly restrictive fiscal and monetary policies, with the inevitable losses of jobs and real output that would be entailed.

Supply-side economics is obviously no cure-all for inflation. But the problem of inflation is so intractable that no single measure to deal with it will suffice. Our only hope for making substantial progress against inflation over the next several years lies in keeping the fight against inflation at the forefront of every economic policy decision. If we recognize its limitations as well as its strengths, supply-side economics can play an extremely useful role in that endeavor.

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