

# *The Politics of Supply-Side Economics*

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We have, in the Congress, a thing called a “budget process.” You may not have noticed it, but it’s there. It was the subject of heated debate when it was established in the middle 1970s, when many legislators who were worried about spending voted for it on the grounds that it would force us all to think about the financial consequences of our various programs, to reconcile them, and to set priorities.

It hasn’t done that. In fact, deficits have gotten worse since the budget process began, and government spending is now approaching proportions of the GNP previously reached only in wartime. What the budget process did achieve was an infallible method of providing rationales for increased spending, usually in terms of an alleged rise in unemployment should government spending be reduced in the economy, but sometimes by means of specialized studies on technical issues. I might add here that the one area where the budget process did act to inhibit spending was defense, where it tended to challenge the specific requests made by the Pentagon and its friends in Congress. By coincidence, this reflected the political priorities of the party controlling Congress at the time and the predilections of the staff members coming onto the Hill during the Vietnam era.

All this happened in spite of the fact that the Congressional Budget Act of 1974 set up a body called the Congressional Budget Office, which was supposed to provide politicians in both Houses with dispassionate, objective, and professional assessments of policy proposals. As it turned out, it was the CBO that provided the arguments for increased spending, and it backed them up with an imposing array of evidence from a variety of econometric models, much of it written in Greek and emanating from computers—which, as you know, never lie. For that matter, since economics is a

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science, many legislators, although puzzled, concluded that economists couldn't lie either, and that if they said deficits were OK, they must be.

There are in reality value judgments at the heart of the Keynesian orthodoxy, and particularly at the heart of the Keynesian proponents. This is not just a matter of Alice Rivlin (the supposedly impartial head of the CBO and one of what *Newsweek* magazine called the "half dozen leading liberal economists") dining with Senator Kennedy to prepare him for his challenge to Mr. Carter last year. (Another CBO projection bites the dust!) It isn't even just a matter of the faulty underlying assumptions contained in the CBO projections, although these are often rather odd. The CBO, as you all know from reading the literature, has for years systematically favored spending increases over tax reductions as a means of stimulating the economy, and, at one time, it was even using a model which assumed that a decrease in corporate taxation would reduce GNP.

Where the element of faith in the Keynesian orthodoxy really comes into its own is in the CBO's steady resistance to any sort of analytical or empirical debate about its assumptions. We had a particularly graphic example of this in the spring of 1980. There is abroad in the Western world at the moment, a particularly lethal weapon that has totally altered the balance of power between employers and the employed. This weapon is called the Xerox machine, and some anonymous dissident on the Budget Committee staff used it to send us a copy of a memo (written to Ed Muskie, then Chairman of the Budget Committee, from his staff director) discussing detailed collaboration between the CBO head and the Democrats on the Committee to suppress Republican efforts for a hearing on the econometric models CBO uses. These models, of course, are under severe attack for ignoring the incentive effect, and we were hoping to get CBO to consider some of the supply-side thinking now going on, of which this conference is a symptom.

The memo told Muskie: "Alice [Rivlin] doesn't really want to have hearings and would like to put Hatch off somehow. She says—and Susan Lepper (the Majority Economist) supports her in this—that the critics of the models CBO uses for forecasting are an extreme right wing clique who should not be given an audience, lest it legitimize their views and give Hatch a forum which should be denied him if we could. If we are to hold hearings, Alice believes they should involve noted economists telling the Committee that Hatch's witnesses are wrong. . . ."

Later on in the memo, the staff director told Muskie: "I am tempted to have him [me] off on this tangent, which few people know or care about outside the economics profession, rather than leave him with time to become involved with something that might be more serious. . . ."

None of this looks particularly objective or dispassionate, or for that matter even scientific, to me. Of course, I'm just a lawyer. I think the sad thing about all of this is that the people involved, whether political appointees like the Democratic staffers or civil servants like the CBO functionaries, are not in themselves dishonest or conniving people. The nature of the system causes them to act in this way because their own short-term interests are so very clearly involved.

Although bureaucrats and politicians—at least certain politicians—do benefit from continual deficits and pervasive inflation, the system is unstable. Inflation is only a temporary answer to the problem of separating the taxpayers of this world from their earnings. For one thing, the dislocation it causes annoys and distresses them. For another, the combination of inflated incomes carrying more individuals into higher tax brackets, and government expenditures which are steadily mounting, means that the underlying resistance to taxes is steadily increasing. More and more people are being pushed into the fiscal free-fire zone. They are reacting by digging fox-holes, constructing tax shelters, and generally refusing to obey orders.

This is a particularly acute problem for the economists of our "ruling class"—because that's what the Keynesians, in effect, are. Their system is entirely set up to suppress insurrections from people who believe in balanced budgets—and there are still a lot of them about, incidentally. All they have to do is show that balancing the budget will cause economic disruption, besides requiring either tax increases or spending reductions. But they don't have any way of dealing with the negative incentives of their system, except more government intervention to divide up the pie or to treat the symptoms of rising prices and wages. This is why we hear so much now about "zero-sum societies," lowered expectations, spiritual malaises, and so on. Tacitus said the Romans made a desert in Germany, and called it peace. We can say of the economic establishment that it has made a stagnant pond, and called it the Great Society. Still, it has been good for real estate prices in Georgetown. And it is causing us to rejoin the human race—with a command economy, with welfare for people and corporations.

In other words, supply-side economics has arrived in exactly the situation the late Harry Johnson diagnosed as existing at the time of the advent of Keynes, at the onset of the Depression:

... On the one hand, the existence of an important social and political problem with which the prevailing orthodoxy was unable to cope; on the other hand, [a new theory with] a variety of characteristics that appealed to the younger generation of that period—notably the claim of the new theory to superior social relevance and intellectual distinction, its incorporation in a novel and confusing fashion of the valid elements of traditional theory, the opportunity it offered to bypass the system of academic seniority by challenging senior colleagues . . . [and] the advancement of a new empirical relationship challenging for econometricians to estimate.

This may sound cynical, but it isn't really. As we have seen, economic policy is an area where even the most qualified professionals seem to have trouble keeping their minds open to new and inconvenient ideas. In that respect, it's unlike academic life—I hope. If any theory is to flourish in this environment, it must be protected by its political mentors. Keynes, incidentally, was fully aware of this and used every trick he could think of to advance his views. He had an extremely active mind, so he thought of a lot of tricks.

The best way of thinking about economic policy is by comparing it to a dog fight between World War II fighters. You have to aim at some point other than at the target itself in order to hit it, given your relative motion and so on. This is something that Keynes understood. He told Friedrich von Hayek that he realized his policy prescription would be inherently inflationary, but that when the moment came he would step in and turn public opinion around in six weeks. When Hayek tells this story, he always adds, with an ironic grin, that six weeks later Keynes was dead. But the point is that Keynes wanted to solve certain problems and he wanted to change policymakers' thinking about them, and the importance they put on them. In a sense, you could argue that there's an element of myth about all economic policy proposals—as defined by the French historian Sorel, who said many years ago that myths in human society were not factual statements, but were instead expressions of intentions to act.

Keynes was successful in getting all of us—not merely liberals—to accept his values. And I believe that those who have developed the supply-side theories will be successful in shifting our attention once again to incentives and production and the economic applications of liberty. As I say, this isn't merely an academic achievement. It is a political achievement of no small merit. What

the supply-siders have done is to point out that the war between the proponents of incentives and the federal government's spending constituencies is not necessary. It is possible to attack at another point: to get tax rates down and stimulate growth sufficiently to pay for the current rate of social services, hence bypassing the question of whether social spending is too high.

Now, will these services be paid for out of tax revenues that have increased absolutely, while decreasing in terms of rates levied on individuals? Or will they be financed out of additional savings generated by increased production? Or will we in fact find further deficits, albeit in the context of a policy that promises to get the country moving again rather than sinking under taxes and regulation? There are various answers to these questions, but in a broader sense, these questions are upstaged by the new awareness in the public debate of incentives—that there is supply as well as demand.

An example of this new awareness came in Mr. Carter's recently proposed tax package, which seems as if it were designed to catch attention as an alternative to Mr. Reagan's tax proposal. No one can deny the White House's exquisite sensitivity to currents abroad in the land—to style, if not to substance. When you look at President Carter's proposals in detail, you can see the extraordinary gains the supply-side offensive has made in the last two years—and also the stubborn and ferocious determination of the economic establishment to maintain and expand its power and that of the government, come what may. A recent H. C. Wainwright study by Paul Craig Roberts shows how President Carter's tax cut is really aimed at objectives other than tax reduction.

In the matter of a few short months over the summer, President Carter went from telling the American people that the \$36 billion tax cut proposed by Governor Reagan would cause "fierce inflation" to proposing a \$27.6 billion tax cut of his own, which he said would be "anti-inflationary." Following on the heels of the Senate Finance Committee's proposal for a \$39 billion tax cut, it put to rest the argument that the Reagan-Kemp-Roth tax cut was bad politics. So we can now move to the merits of the proposals and determine which would provide the most incentives to increase production.

By comparison, the Kemp-Roth tax cut bill proposed by Governor Reagan is clearly a supply-side proposal, since it concentrates solely on reducing marginal tax rates. Measured by static revenue losses, it is more heavily weighted toward

“individual” rather than “business” tax reductions. The Senate Finance Committee bill, although it wastes about \$7 billion on enlarging the zero bracket amount, personal exemption, and earned income tax credit, is largely an application of incentive-oriented supply-side economics. It gives 56 percent of its cut to individuals and 44 percent to business. President Carter’s proposal is more heavily weighted toward business, giving it 55 percent of the cut. But, although the Carter proposal is cloaked in supply-side rhetoric, a closer look shows that it is designed to achieve ends quite different from lowering marginal tax rates or increasing production incentives.

One example is the refundable investment tax credit. The purpose of the investment tax credit is to boost the incentive for investment in new equipment; there is no economic sense to excluding firms with no tax liability. It is often new and rapidly growing firms that have no tax liability against which to apply a non-refundable credit. But the main problem with the refundable investment tax credit is the precedent it establishes. How could we hope to avoid making, say, the child care tax credit refundable for poor people if big business has it? The child care tax credit is expensive—up to \$800 per eligible return—and making it refundable would be a big step toward expansion of the federal welfare system.

The refundable investment tax credit would also expand the federal welfare concept to business. It would establish the concept of extending the dole to businesses that lose money. It would result in an institutionalized bail-out scheme instead of making the Congress consider it on a case-by-case basis. This is hardly the way to “make careful investments in American productivity”—Carter’s way of differentiating his tax cut from Reagan’s.

Another part of the President’s proposal that will contribute to the growth of government intervention in the economy is the additional 10 percent refundable investment tax credit targeted to revitalize depressed areas. Firms that want to qualify must obtain certificates of necessity from the Commerce Department, but the criteria for determining eligible areas are not defined. This would give the government the ability to reward its friends and withhold the credit from the uncooperative. Even if the system could be kept free of political corruption, government allocation of resources will certainly reduce efficiency in the economy.

We should also note that President Carter is also suggesting that the Treasury Secretary be given the power to adjust depreciation rates at will. This is another expansion of the government’s

discretionary power. And it's likely that the accumulated effect of his proposed substitution of open-end for vintage accounting will tend to reduce the present value of the depreciation allowance for technical reasons. So the pro-business aspects of Mr. Carter's plan can be—and have been—exaggerated.

On the individual side of the Carter tax package, an income tax credit is used to partially offset the scheduled increase in the social security tax out of general revenue funds. Instead of reducing marginal tax rates, it is a scheme to redistribute income and turn social security into a welfare program by taking the first step into general revenue financing. If the President were really interested in avoiding the economic damage that will result from the social security tax increases, he could just postpone or repeal the scheduled increase. The only reason for the income tax credit approach is to attack the contributory nature of social security and plunge into general revenue financing. This type of tax cut is likely to guarantee continuing revenue losses and deficits. Although it has the smallest static revenue loss, it would probably be the most expensive, net of feedback, because of the negative supply-side effects.

On the whole, the Carter tax cut encompasses the welfare rather than the incentive approach to tax policy. Most of its provisions increase the discretionary power of the government to control the economy. It would divert resources from economic to political uses, and would lead to deficits and revenue losses that would prevent us from getting the incentive tax cuts the economy needs to grow.

Furthermore, the Democratic Platform contains 70 separate items that will result in federal government spending. Over the next five years, the platform would cost \$608 billion in budget authority and \$431 billion in outlays. In comparison to the Senate Budget Committee's second budget resolution for FY 1981, the Democratic Platform would add \$74 billion in budget authority and \$30 billion in outlays in FY 1981, and \$566 billion in budget authority and \$389 billion in outlays over the FY 1981 to 1985 period. If enacted into law, the Democratic Platform would cause federal outlays to increase to 24.7 percent of GNP in 1982, and this includes no additional outlays for interest on the public debt due to the higher deficits. Coupled with President Carter's tax cut, it would create a \$261 billion deficit over the next five years as opposed to the \$75 billion surplus Governor Reagan's plan would create.

I want to conclude tonight by commenting on the checkered fortunes of the tax revolt since it first materialized in California in

1978. Since then, it has been periodically proclaimed to have run out of steam. Certainly the lobbying groups arrayed on the side of increased spending still seem to be alive and dangerous; victory has been by no means as automatic as it first appeared it might be. But it might be remembered that we are fighting a momentum that has built up over a period of decades. The proponents of income redistribution, deficits and government intervention took years to perfect their appeal to the broad electorate, and to overcome the doubts, scruples and skepticism of the American people about charity, the expropriation of property, and the surrender of independence that the welfare state entails. It will take us years, too—although the success we have had in forcing our opponents to steal our rhetoric is evidence of some sort of progress. And in the end, our task will be easier. It is the processes of liberty that we are fighting for, and they are intrinsic to the American tradition. After all, it was a dispute over taxation that triggered the American Revolution. It is not surprising—it is, indeed, highly appropriate—that we should have gathered here to think about tax policy in the consciousness that what we have been doing in reality is to contemplate at least the success and perhaps, ultimately, the survival of liberty itself.