

*PART IV:
LUNCHEON
AND DINNER
SPEECHES*

The Power of Negative Thinking: Government Regulation and Economic Performance

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Let me start off with a proposition duly overstated—which should fit comfortably with the remarks of other contributors to this conference on supply-side economics: it is futile to focus so heavily on tax incentives to encourage economic activity at a time when the governmental regulatory apparatus is imposing such a vast and rapidly expanding array of obstacles to economic activity.

The lack of parallelism in my language is deliberate. It is not just a matter of the disincentives of regulation offsetting some of the incentives which can be provided by tax reform. Rather, it is a case of insurmountable government-imposed barriers which any increases in the normal, after-tax rate of return can do little to hurdle.

For example, the most generous of tax credits will not help a company to market a product that has been banned by the government. The most liberal depreciation allowance will not assist a firm in obtaining the numerous permits which are essential to the operation of a new power plant. Indexing income tax rates will not encourage the job applicant who is turned aside by companies administering government-imposed quotas in their hiring. Nor will massive reductions in personal income taxes help the teenager who is priced out of the labor market by the latest increase in the compulsory minimum wage.

Of course, this is not truly a matter of either/or. We need not and should not choose between tax reform and regulatory reform. Rather, we should understand that the two go together. In practice, supply-side tax cuts and reductions of regulatory burdens are

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mutually reinforcing. Both can increase the capacity of the economy to produce goods and services, the willingness of investors to take risks, of management to innovate, and of workers to produce.

To put it less dramatically, but more specifically than I did in my opening statement, tax reform is a necessary but not sufficient condition for substantially improving the performance of the American economy. We must simultaneously deal with what I call the power of negative thinking—the ability of, or at least the tendency for, the regulatory apparatus (in truth I cannot call it a system) to make economic activity difficult to perform. So many government regulatory agencies have the power to say no to new economic undertakings; few, if any, have definite authority to say yes. To the typical entrepreneur, government is not a source of help, but the possessor of the power to stop or at least to delay and confuse. As a federal judge recently declared, “The federal bureaucracy is legally permitted to execute the Congressional mandate with a high degree of befuddlement as long as it acts no more befuddled than the Congress must reasonably have anticipated.”

It is fascinating to consider the attitudes of the proponents of that increased regulation: they view the modern corporation simultaneously as venal and omnipotent. That is, they implicitly assume that society can impose an endless variety of so-called social responsibilities on the business firm without affecting its basic ability to carry on its economic function, that of meeting consumer needs for goods and services.

To bolster my point, let me cite high authority, a recent issue of the magazine *Mother Jones*. The editor was reporting on a conference of business executives that he had recently attended. He explained his surprise at the attitude that he had encountered. As he put it, “We had come to view executives as the sort of men who blithely market fire-trap cars, fill the Love Canal with lethal chemicals, dump hazardous products on Third World countries and conceal the dangers of asbestos from their workers... To have perpetrated so much, unscathed—surely they must be a strong, confident breed, boldly planning new drives for profits.”

That is not satire, but journalism, I keep reminding myself. But the *Mother Jones* editor, to his surprise, found a different spirit among the executives, who “saw themselves as innocent, aggrieved producers—unfairly assaulted by environmentalists [and] regulatory agencies...” He went on to point out, “The corporate sector, we

discovered, felt besieged. Barry Commoner, Ralph Nader, Leonid Brezhnev, Teddy Kennedy and Jane Fonda were all out to get them.”

It is not my purpose today to evaluate the innocence or the guilt of American business executives (whatever that would mean), but to point out the economic consequences that result from the massive range of government intervention in economic activity—which, in turn, has resulted from the pressures of the self-styled public interest groups. Subsequently, I will try to show how any effective, supply-oriented approach to public policy can take account of this phenomenon.

THE MANY COSTS OF GOVERNMENT REGULATION

Most public and professional attention to the costs of government regulation has focused on the direct burdens of complying with government directions. You may recall my estimate that, at the federal level, these costs were in the neighborhood of \$100 billion in 1979 and rising rapidly. Granted the imperfections of my rudimentary techniques—I note that nobody else has attempted to take on such a task—I now acknowledge the important costs of regulation that I neglected to take into account in my computations.

Let me enumerate some of these costs. It will become clear soon enough why I did not include them in my numbers. I am referring to the induced effects of regulation, the most diffuse and elusive aspect of measuring the impacts of regulation. But for the policymaker, what is truly important is not the precise dollar quantities but the direction of the impacts. Clearly, most of these induced effects of regulation impair the basic ability of the American economic system to perform. Let me enumerate the key types of induced regulatory costs.

1. *The innovative product and process research and development that is not undertaken because corporate research and development budgets increasingly are being devoted to what is termed “defensive research.”* Many companies report that they devote large and growing shares of their scientific resources—from one fifth to one half—to meeting regulatory requirements or avoiding running afoul of regulatory restrictions. Surely, the longer it takes for a new product to be approved by a government agency and the more costly and uncertain the approval process, the more likely that innovation will be delayed and the rate of innovation reduced.

Invariably, it is discouraging to the innovative instincts of business firms to undergo experiences like the one recently had by

Monsanto, the chemical company, with its recyclable plastic bottle for soft drinks. The Food and Drug Administration banned this new product because it was made with acrylonitrile. The regulators say that if the bottles were filled with acetic acid (and not soda pop) and stored for six months at 120°F., an infinitesimal amount of the acrylonitrile could leak into the solution—and that would constitute a carcinogenic (and hence unlawful) food additive. On the basis of this less than brilliant experiment, Monsanto closed down all the factories making the product and laid off several thousand workers.

But these problems are not just a matter of large companies or of one obstinate government agency. A small R&D oriented company, Nutrilite Products, reported similar negative experiences. After repeated efforts to obtain approval for a new “biological” form of insect control (instead of the more environmentally hazardous but traditional “chemical” approaches), the company concluded, “We’re going back to making vitamin supplements and trying to stay as far away as possible from the Environmental Protection Agency.” In effect, government is building what Lee Loevinger, former chairman of the Federal Trade Commission, calls “‘legal envelope’ around existing technology.”

2. *The new investments in plant and equipment that are not made because of regulatory barriers and the diversion of investment funds to meeting government-mandated social requirements.* The cost of potential new investments is raised by the uncertainties generated in the permit-approval process and by the cloudy future of new rounds of regulation. Delays surely have become the order of the day. In 1975, it took Deere and Company, the agricultural equipment manufacturer, only three months to receive a complete environmental permit review for constructing a new plant. Currently, Deere estimates the lag at two years. Although the company has received most of the permits it has requested, it reports that EPA has insisted that these permits contain reopener clauses in case the agency adopts more restrictive standards in the future. In another instance, after noting that 42 different federal, state, regional, county, and municipal agencies regulate his new aquaculture company, George Lockwood, president of Monterey Abalone Farms, stated in a paper to the AAAS that the major problem is not the direct costs of compliance but “the great uncertainty” about whether any new activity will meet rapidly changing regulatory standards.

Professor Ossar Lindbeck of the University of Stockholm has commented on this phenomenon which apparently is not unique to

the United States. He points out that if laws and regulations change "violently" all the time, the returns accruing from correct speculation about the next moves of the regulatory authority often become higher than the returns from careful investment in skills, product development, choice of production technique, and marketing. Professor Lindbeck contends, and I tend to share his concern, that the sluggish behavior of investment activity in most Western economies during recent years is derived not only from low short-term profits, but also from increased uncertainty about future government policies and the future rules of the game.

The problems facing firms which introduce new technology are especially great. Here is the assessment of a task force of the U.S. Energy Resources Council on the overall impact of regulatory activity on the establishment of a new energy industry: "In summary, some of these [regulatory] requirements could easily hold up or permanently postpone any attempt to build and operate a synthetic fuels plant." The recent cancellation of the SOHIO pipeline project provides striking evidence that the regulatory uncertainties are not limited in their adverse impacts to new technologies or even controversial ones.

Where government approvals are forthcoming, we find that a rising share of company investment is being devoted to meeting governmentally imposed social requirements. In recent years, outlays mandated by EPA and OSHA have come to about 10 percent of new capital formation in American industry. In a pioneering study, Edward Denison estimated that the diversion of this amount of new capital resulted in business productivity in 1975 being 1.4 percent lower than it otherwise would have been. One percent may not seem like much but, in recent years, that would have been the difference between a rise and a fall in the overall productivity of the economy.

Moreover, we cannot always assume that the loss of private productivity is offset by an improvement in some area of social concern. For example, Armco Steel Corporation was required to install special scrubbing equipment at one of its plants to reduce the emission of visible iron oxide dust. The scrubber does succeed in capturing 21.2 pounds per hour of the pollutant. However, it is run by a 1,020-horsepower electric motor. In producing the power for that motor, the electric utility's plant spews out 23.0 pounds per hour of sulfur and nitrogen oxides and other gaseous pollutants. Thus, even though Armco is meeting government regulations on visible emissions, the air is actually 1.8 pounds per hour dirtier because of the government's regulatory requirements.

The Armco case is no isolated example. Scrubbers are increasingly becoming required equipment for electric utilities that are attempting to comply with EPA regulations. The federal agencies, by being unable or unwilling to consider the adverse but indirect effects of their actions, are likely to produce more instances in which unintended but undesirable side effects swamp the benefits. Consider the sad story of the Pennsylvania Power Company. That utility has a new 825-megawatt complex that utilizes scrubbers. In extracting the pollutants from coal, it produces 18,000 tons of sludge a day. To dispose of the sludge, the company has been forced to build a 350-foot-high dam, the largest earth and rock embankment east of the Mississippi River. Behind the dam, there is now a lake of sludge, which already covers 900 acres in a picturesque valley of Western Pennsylvania!

Moreover, the regulations issued under the 1977 Clean Air Act Amendments will slow down, if not halt, industrial expansion in many parts of this nation. If and when the rulings are fully enforced, failure of a state to win EPA approval of its detailed clean air plan will result in an absolute prohibition of any new industrial construction in that state.

3. *The workers that are not hired because federal regulations have priced them out of labor markets.* A variety of serious academic studies has shown that the steady increases in the statutory minimum wage have reduced teenage employment significantly below what it otherwise would have been—without a comparable offsetting increase in adult employment. The Davis-Bacon Act yields similar results in government-financed construction—lower employment and higher inflation rates.

4. *The immeasurable effects of government regulation on the basic entrepreneurial nature of the private enterprise system.* To the extent that management's attention is diverted from traditional business concerns to meeting government requirements, a significant bureaucratization of corporate activity results. Many chief executives now report that one third or more of their time is devoted to governmental and public policy matters.

Donald Rumsfeld, chief executive of a major drug company and former Congressman and Secretary of Defense, has described very personally the pervasiveness of government involvement in business:

When I get up in the morning as a businessman, I think a lot more about government than I do about our competition, because government is that much involved—whether it's HEW, IRS, SEC, FTC, or FDA. I always understood the problem intellectually, but the specific inefficiencies that result from the government injecting itself into practically every aspect of our business—that is something one can feel only by being here.

This bureaucratization of entrepreneurial activity, albeit undramatic, is not of modest dimensions. Professor Douglas North of the University of Washington contends that the key margin of decision making in our society today is access to government influence. As he describes the matter, the predictable result is "to shift the focus of the investment of resources into attempts to favorably influence the strategic government official or to prevent the enactment of government policies that will adversely affect the interest of groups." The point may be overstated. There are still many more opportunities for private undertakings. Moreover, the adverse public reaction to massive use of business resources in politics would, under present circumstances at least, be overwhelming. Nevertheless, North is indicating an important emerging development, especially in the case of the larger business organizations.

Furthermore, Professor Lindbeck, from his different vantage point, has made a similar observation. As he puts it, "there will be great temptations," particularly for large firms, to bargain with politicians over the rules and to seek various "deals" with governmental authorities. Lindbeck notes the risk of businesses entering into "zero-sum games" where they concentrate on bargaining with governments rather than trying to increase output.

APPROACHES TO POLICY CHANGES

It may, however, be easier to identify the regulatory problem areas than to develop effective strategies for change. At the outset, we must recognize the source of many of the pressures for regulation—the self-appointed, self-styled public interest groups. Large segments of the media, as well as many legislators, view these groups automatically as both "representatives" and as underdogs. This simpleminded attitude results in the characterization of people who disagree with them as the "heavies." But just because I may disagree with Ralph Nader or Jane Fonda should not inevitably be taken as my representing some special interest opposed to the public welfare. Why not think the unthinkable? It just may happen that, on occasion, Ralph (or Jane) may be wrong.

Many—but not all—representatives of the public interest groups confuse their personal prejudices with the national well-being. Surely, I do not claim to represent the public interest. In all of my years in government, I never met a mortal man or woman who truly represented *the* public interest. As someone who was intimately involved in government policymaking, I know that

making good policy is far more difficult than merely choosing, in a simpleminded fashion, between “public” or “consumer” interests (which are presumably good and to be supported) and business interests (which are presumably evil and to be opposed). Effective policymaking consists not of dramatic confrontation, but of carefully balancing and reconciling a variety of legitimate interests—such as clean air and low inflation, safe products and high employment, healthy working conditions and rising productivity.

In addition, the one thing this new breed of interest groups lack is a sense of humor. For example, they attacked OSHA for stopping the distribution of one of its pamphlets. OSHA had issued a pamphlet on farm safety which treated farmers like dummies. One of the newspapers in the nation’s farm belt answered with the following editorial in the form of a Dick and Jane book, the kind you read in the first grade. Let me read it so you can decide for yourselves.

DICK AND JANE VISIT THE FARM

See the book.

See the little book.

See the little OSHA book.

What is OSHA?

OSHA is your government.

OSHA is the Occupational Safety and Health Administration.

OSHA helps people.

OSHA helps people to be safe.

OSHA made the little book for farmers.

What does the little book say?

This is what it says:

“Be careful around the farm . . . hazards are one of the main causes of accidents. A hazard is anything that is dangerous.

“Be careful when you are handling animals. Tired or hungry or frightened cattle can bolt and trample you. Be patient, talk softly around the cows. Don’t talk fast or be loud around them. If they are upset, don’t go into the pen with them.

“Be careful that you do not fall into the manure pits. Put up signs and fences to keep people away. These pits are very dangerous.”

See the farmer.
 See the farmer go to the mail box.
 See the farmer get the little book.
 The farmer can read.
 The farmer can read big words.
 The farmer can read long sentences.
 The farmer knows about fences.
 The farmer knows about manure pits.
 Now the farmer knows about OSHA.
 See the farmer kick the mail box.
 Hear the farmer say bad words.
 See the farmer throw the little book.
 See the farmer throw the little book into the manure pit.
 See OSHA.
 See OSHA write.
 See OSHA throw money into the manure pit.
 Say bad words about OSHA.

Basically, we have to realize that the variety of regulatory activity requires a variety of reform approaches. Eliminating regulation makes good sense in those areas where the consumer is better served by market competition. Energy is a prime example. Eliminating the entire apparatus of energy price restrictions, allocation controls, entitlements, and reporting requirements would result in more domestic production, more conservation, and reduced imports of foreign oil. Deregulation of airlines, trucking, and railroads are also good examples of regulatory reform oriented to supply-side concerns.

For the social regulations, there is no good alternative to revising the basic statutes under which the regulations are promulgated. The zero-risk approach of the Delaney Amendment to the Food, Drug, and Cosmetic Act is a cogent example of unrealistic and unreasonable social regulation which can be effectively curtailed only by rewriting the law. Given the multiplication of regulatory statutes, what would truly help is, yes, yet another statute, one requiring compulsory benefit/cost tests. Each agency should be required to demonstrate in advance that its rulings will generate more benefits to the nation than costs—hopefully, that the marginal benefits equal the marginal costs and that it has chosen the most cost-effective approach.

The promulgation of rules, of course, is not the only means of accomplishing public objectives. As economists have been trying to

explain to government decision makers, pollution taxes could constitute a far less costly method of achieving water quality objectives. Interestingly enough, the business community, which shows little enthusiasm for regulation, is adamantly opposed to this use of the price system. Not that it is necessarily relevant, but I note that environmental standards, unlike pollution taxes, tend to be rougher on new industries than on established facilities. But as we have learned over the years, the most adamant foe of government intervention eventually learns how to convert a government rule to a barrier to entry. As Lee Loevinger has noted, "Thus small enterprises are slowly squeezed out and barriers to entry are established by government fiat that would make an old-fashioned monopolist either envious or embarrassed."

In many other areas of government intervention, notably consumer product safety, an information strategy is an alternative to compulsory standards or product bans. Interestingly enough, this approach often is favored in consumer surveys, although not by the more vocal consumer organizations.

A word of caution: any realistic appraisal of government regulation must acknowledge that important and positive benefits have resulted from some of the regulatory activities—less pollution, fewer product hazards, a reduction in job discrimination, and other desirable goals of our society. But the "externalities" generated by federal regulation do not justify government attempting to regulate every facet of private behavior.

CONCLUSION

To sum up: the response of the economy to supply-oriented tax policy will be greatly enhanced by reducing the numerous regulatory obstacles to economic activity. Failure to eliminate or at least substantially cut back the regulatory inhibitions to work, invest, and produce will result in disappointing returns from tax policy changes.

Government policymakers must come to realize the lack of symmetry in the two different policy mechanisms: tax changes can provide strong incentives to undertake private economic activity, but regulation can provide a simple but effective veto. Too many of the debates on supply-side economic policy have ignored or at least deemphasized the crucial power of negative thinking on the part of the regulatory apparatus.

The Politics of Supply-Side Economics

ORRIN G. HATCH

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.

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