

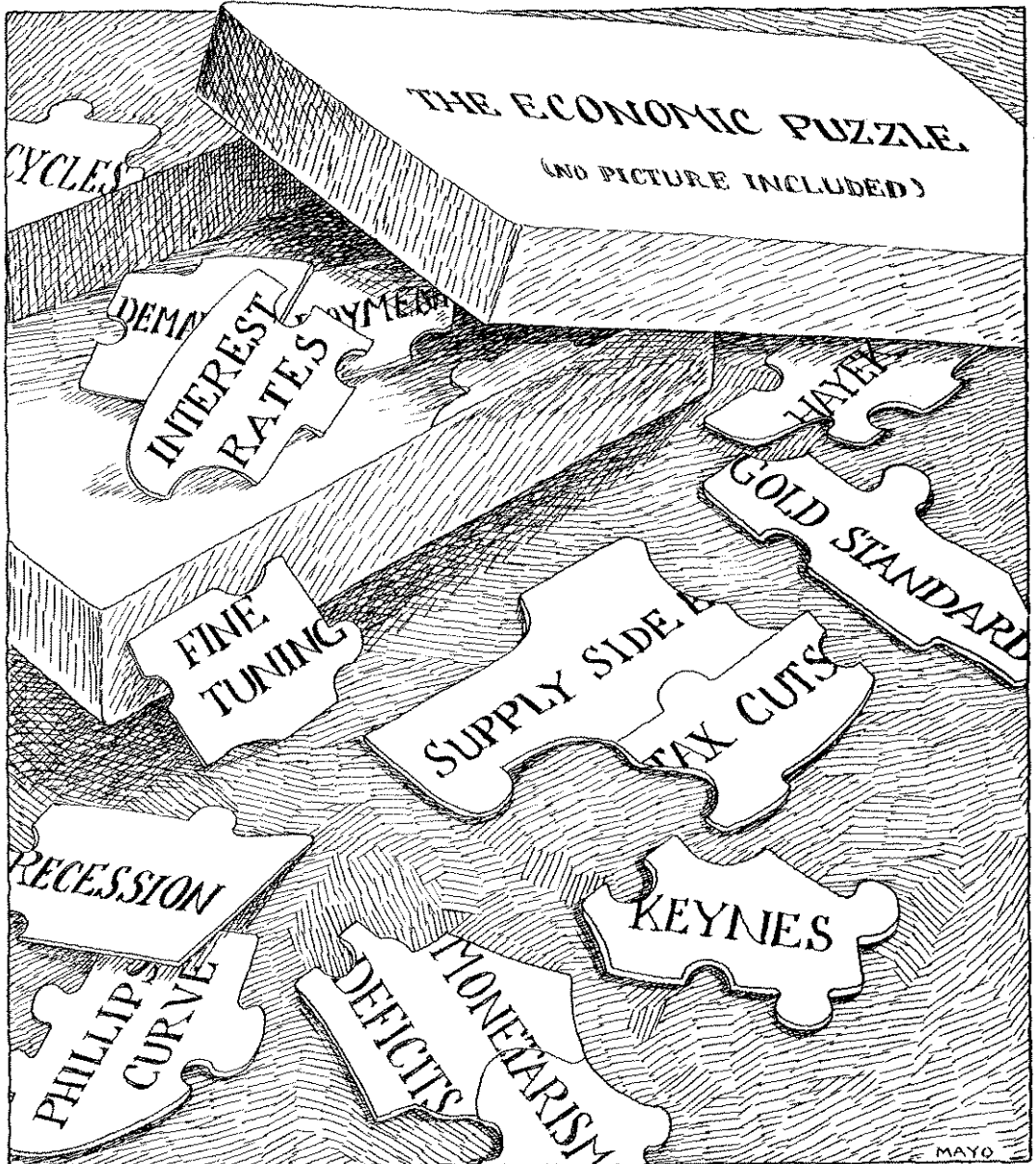
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Idle Resources, Easy Money, and Hard Choices: Toward an Understanding of the Crisis



"In political economics, the day of the Neanderthal Man—indeed, the day of the pre-Keynesian Man—is past."

—Walter Heller, *New Dimensions in Political Economy* (1967)

From his post as Chairman of the Council of Economic Advisers in 1967, Professor Heller confidently proclaimed a "growing consensus on the analytical core of economics," buttressed by "lessons of performance well done that will not be early undone." Indeed, reflecting a near decade of robust growth, even President Richard Nixon announced his conversion to the new economics four years later: "We are all Keynesians now."

But the boom of the 1960s gave way to the bust of the 1970s, and with the 1980s arrived a new age of uncertainty. Clearly, Professor Heller's consignment of "pre-Keynesian Man" to the historical dustbin was a bit premature.

The performance of the economy in the 1970s caused economists and politicians to unlearn their lessons, and rather earlier than the confident demand managers predicted. "The raw fact that hits everybody is that the economy has just not behaved according to the best Keynesian models," the well-known University of Minnesota economist Thomas Sargent noted in 1978. "We were good Keynesians once, but we had to change our minds." And their models, also. For the highly touted and much relied upon tradeoff between inflation and unemployment broke down. It was, to put it in a nutshell, the ever rising "misery index"—the sum of the rates of inflation and unemployment—that sank the leaky Keynesian boat.

Non-Keynesian economic theory is becoming once again academically respectable. Moreover, a new, "supply-side" political program of tax rate reduction, slower money supply growth, and a return to the gold standard has promised to cure inflation without the recession and unemployment traditional anti-Keynesians, such as F.A. Hayek, have always insisted is inevitable. But the supply-side answer to the dilemmas of Keynesian demand management has elicited strong criticism—and political problems of its own.

The Manhattan Institute conducted separate interviews (here run concurrently) with Professors Anna Schwartz of the National Bureau of Economic Research, a noted monetarist; Robert Lucas of the University of Chicago, a leader of the off-shoot of monetarism known as "rational expectations"; and Robert Mundell of Columbia University, one of the intellectual godfathers of contemporary supply-side theory. What have we learned from history and from our current deep recession? Where do we go from here? The participants examine these and other questions. We also offer a synthesis of monetarism and supply-side theory recently suggested by Professor David Meiselman of Virginia Polytechnic Institute and State University. Professor Meiselman's proposals were first made in March of this year at a conference in Atlanta, Georgia.

MANHATTAN REPORT ON ECONOMIC POLICY

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Idle Resources, Easy Money, and Hard Choices: Toward an Understanding of the Crisis

Manhattan Report—John Maynard Keynes's *General Theory of Employment, Interest and Money* (1936) was designed to give government policymakers a guide for full employment policy, and his general framework was very widely accepted in this country. The Full Employment Act of 1946, for instance, is fundamentally Keynesian, and virtually every textbook written in the last thirty-five years has reflected Keynesian assumptions.

Today, it seems, many economists, and perhaps the public too, have lost confidence in Keynesianism. Would you discuss your judgment of Keynes's approach to macroeconomic management?

Robert Lucas—I've lost faith in Keynesian theory as a body of doctrine that's suitable for making the Employment Act of 1946 work. I think it presupposes knowledge of the structure of the economy that doesn't currently exist. Whether the public agrees with me, I don't know. My impression is that, while the public seems disillusioned with establishment economists, it is hoping that some wizard will come up with something new. So there's a lot of receptivity to crackpot economics.

Anna Schwartz—The underlying assumption of Keynes's approach is that the private sector is unstable, requiring periodic correction by fiscal policy changes to stabilize it. The validity of that assumption is highly questionable. Postwar experience suggests that destabilizing actions by public agencies dominate private sector behavior. To say the very least, fiscal policy has been badly timed, acting as a net destabilizer.

Robert Mundell—Well, Keynesianism is indeed a way of managing the economy. When there are a lot of unused resources in the economy—capital and labor resources—and no markets for them, then expansionary fiscal policies in the form of tax cuts or government spending can be useful and may even be necessary. The danger, of course, is inflation. In the 1930s this was no problem. Interest rates were very low—2 percent or less—and there were no huge budget deficits.

Now, after years of Keynesian-type policies and some degree of success in the sense that we've avoided really major depressions, we've reached diminishing returns. We've run into problems of confidence, inflationary expectations, and so on. Demand-side monetary and fiscal policies, as monetarists and Keynesians prescribe, have really reached the limit of their usefulness. We have to follow other avenues.

MR—Did Keynesian stabilization policies ever work?

Anna Schwartz—Keynesianism seemed to work for a time, although in our book, *A Monetary History of the United States 1867-1960* (1963), Milton Friedman and I related that to the stable monetary growth after 1947. Admittedly, that stability may in part be a statistical construction, because before 1947 we have only single-date monthly measures of monetary growth. After 1947 we have monthly averages of daily figures, which may have a smoothing influence on the monthly pattern. Still and all, there is a decided difference between the erratic movements in monetary growth before 1947, and the stability that came after and continued up until the inflated period of the 1970s.

Robert Mundell—Keynesian policies were not really adopted in the 1930s, partly because the level of government spending was low in relation to GNP and there were no tax cuts of any appreciable kind introduced. Roosevelt was obsessed with balancing the budget, and unemployment was still as high as 9 percent after ten years of the New Deal. Government spending programs were visible and significant, but they were not large in relation to the economy. The first major adoption of Keynesian policies in the U.S.—large deficits plus expansionary monetary policies—occurred during World War II. In the 1930s Keynesian policies flourished only in Nazi Germany under the influence of Hjalmar Schacht, Hitler's Minister of the National Economy.

After the postwar recession of 1949-1950, increased government spending arising from the Korean War raised both the price level and the level of employment. I should also mention the tax cut in the Kennedy-Johnson era, which was justified partly on Keynesian grounds. What Kennedy proposed in 1962-63 was a change in what had up to then been a wrong policy mix (called the Samuelson-Tobin neoclassical synthesis) of easy money and budget balance or surplus. It was a movement to tight money to protect the balance of payments and prevent inflation, and a tax cut to increase employment and stimulate the economy out of its growth stagnation. It was a resounding success until the Fed became too liberal in 1965.

Keynesian tax-increase policies designed to stop inflation in 1968 didn't work. The 10 percent surcharge didn't stop inflation. Instead, it played a part in creating the following recession.

MR—Some economics textbooks written today claim that economists never offered policymakers a choice of trading off inflation for unemployment. But this seems to contradict what the profession, or at least a significant part of it, did say.

Anna Schwartz—That's right, I think many economists did say that. The 1958 article in *Economica* by the British economist A. W. H. Phillips was really the initial statement of that tradeoff, which came to be called the Phillips Curve. The Phillips Curve was enormously influential. It just became part of the received wisdom. Arthur Okun, James Tobin, and Alvin Hansen, for example, all believe it.

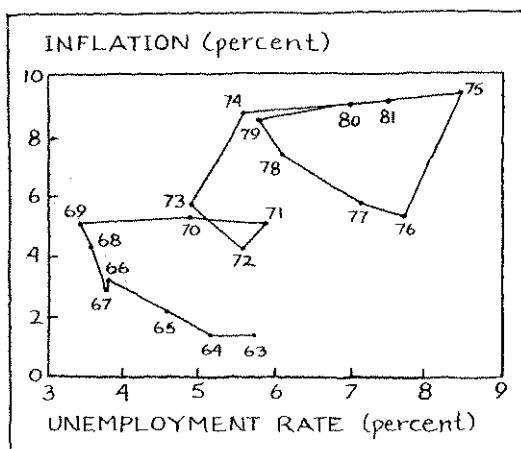
Robert Lucas—The Phillips Curve is dead. That's easy to see after the fact. It wasn't so easy to see fifteen years ago. The Phillips Curve is the relationship between transient or surprise inflations and unemployment; it doesn't have anything at all to do with sustained inflations.

Look at Latin America, where there are countries with massive inflations that are no more prosperous and have no better employment record than countries with stable prices. There is a lot of evidence that sustained inflation doesn't buy you anything in terms of a higher standard of living.

Robert Mundell—There is a relationship between unemployment and inflation insofar as there is a relationship between unemployment and the rate of change of wages, which of course influences inflation. Wages are a part of the cost of living, and they play a big part in the consumer budget, so there's a relationship between the rate of inflation and unemployment. But that is a short run adjustment factor applicable to a given state of expectations.

Keynesians believe the relation between unemployment and inflation is negative and that the Phillips Curve is stable and fixed. The monetarists, following Friedman, believe that the Phillips Curve — although they don't like to use that term — is vertical at what is called the "natural" rate of unemployment. The third group — the supply-siders — believe that the Phillips Curve can be shifted favorably by an appropriate mixture of monetary and fiscal policies. Particularly, one can get a more favorable Phillips Curve tradeoff by changing the policy mix from a purely inflationary monetary policy to a tighter one in conjunction with substantial fiscal stimulus to the economy that aids both productivity growth and effective demand. Under a fixed exchange-rate gold standard, of course, monetary policy is self-governing, and the scope for macroeconomic policy lies in the level and mix of tax and spending policies.

MR—Keynesian demand management policy-makers — Walter Heller comes to mind as the most significant member of this group — claimed to have solved the problem of business cycles in the late sixties, based on their apparent success.



The Phillips Curve— *Where is the Tradeoff Between Inflation and Unemployment?*

How do you account for their success and what did you predict would be the outcome of their policies?

Anna Schwartz—It was predictable that inflation would accelerate because the Fed had accelerated monetary growth. The other view — that there is a tradeoff between inflation and unemployment and that we can keep the inflation rate moderate and still ensure full employment — turned out to be wrong. Even Tobin eventually granted that inflation was worse than he had anticipated, but he still argued that it was possible to keep the inflation rate moderate, and that inflation was acceptable anyway because people had jobs.

We must recall that in the sixties the economy started from a very low inflation rate. A lot of monetary and fiscal expansion was possible before the ill effects became visible. If we began the 1960s with the level of inflation we began with in the 1970s, our perceptions of policy-making might well have been different.

Robert Lucas—My interpretation of the sixties — and the fifties as well — is that the main ingredient of policy was not so much fine tuning, although people may have thought that that's what they were doing, but a smoothing of instability in both monetary and fiscal policy relative to the seventies.

Robert Mundell—Policymakers in the 1960s had two great advantages. First, the gold exchange standard meant they had to protect the value of the dollar by paying attention to the balance of payments. That kept monetary policymakers from making too many mistakes, although monetary discipline weakened after Congress scrapped the gold cover provisions. The other advantage was the 1964 tax cut, put through

"When Keynesian economics discredited the idea that deficit spending on a sustained basis is a very bad thing, it unhinged the system."

—Robert Lucas

over the heads of a lot of the "Keynesians," who objected to it in their support of the neoclassical synthesis.

MR—In the heyday of Keynesianism, business cycles were relegated to the history of theory. But with the loss of confidence in economic fine tuning, there has been a renewed interest in business cycle theory. How do you feel about this development? Is the business cycle obsolete?

Robert Mundell—In part, we create business cycles because every government wants to look good before the electorate around election time. There is a tendency to follow tough but necessary economic policies after an election and then "shoot up" the economy as new elections near. Such artificial business cycles will be with us for some time to come, at least until we restore the international discipline based on fixed exchange rates and gold or find some other workable system.

Yet business cycles are caused not only by economic politics, but also by new investment opportunities, innovations, and raw material scarcities that require reallocation of labor and capital. Business cycles will always exist as necessary responses to such changes, although good policy can tame their severity. If we can't eliminate business cycles, we can at least use them as opportunities to weed out past mistakes in legislation and so restructure our economy, which is our basic strength.

Anna Schwartz—Here at the National Bureau of Economic Research (NBER) we kept on studying business cycles through thick and thin. Business cycles were never obsolete here.

The traditional kind of work that NBER did in business cycles involved looking for empirical regularities. Milton Friedman and I looked for empirical regularities too, but we had some kind of theoretical framework which could account for these regularities. Geoffrey Moore also did a lot of work here in business cycles and he attempted to explain regularity in specific processes covered by his data, but not in a comprehensive framework such as we used. For us the business cycle was explained essentially by changes in the rate of monetary growth. Robert Lucas has a more refined analysis that stresses unexpected changes in monetary growth to which agents respond on the basis of limited information, but we started with the much simpler proposition that an increase (an unexpected shock) in the rate of growth will produce an expansion in business activity, and that a decrease will produce a recession. In the Lucas formulation, agents initially confuse absolute and relative price changes. Other economists,

notably Karl Brunner and Allan Meltzer, see the limited information problem as arising from agents' initial inability to distinguish transitory from permanent shocks.

MR—That brings us to the theory of rational expectations. Dr. Lucas, what about your theory of rational expectations? How does it differ from previous explanations of business cycles?

Robert Lucas—Rational expectations is based on an idea that Jack Muth advanced back in the early sixties. It's really a suggestion of how to incorporate expectations into economic models. Economic models are attempts to describe individual decision-making problems, and since any economic decision depends on what people expect to happen in the future, the principle of expectations is a very important one. Rational expectations theory really is an extension of the idea that there are no profit opportunities lying around out there in the economy up for grabs. Rational expectations are what force internal consistency in economic models. The theory is important in macroeconomics because there was no consistency in the mainline Keynesian models. They left open the possibility—they actually predicted—that individuals would make the same mistakes in the same direction year in and year out. There were no corrective mechanisms built into these models.

In forecasting inflation, for example, the Phillips Curve model assumed that a recurring annual inflation rate of, say, 10 percent would be a surprise each year. People were supposed to begin the year expecting stable prices, their previous experience notwithstanding, and each year the same inflation would supposedly take them by surprise. This assumption was built into the basic equations of the models. If you take into account how people actually behave, it's obvious the old models would make the wrong forecasts.

However, business cycles are difficult to reconcile with any kind of rational expectations. They are collective mistakes, periodic wastes of resources. They do harm and don't do anybody good. The question is: if we assume people are economic men acting in their own self-interests, how is it that these intelligent people make the same mistakes over and over again? That's a hard puzzle. I've tried to answer it by considering the importance of information. An intelligent person will make a mistake if he's somehow short on relevant information and if the signals he thinks meant one thing in fact mean something else. I think that is the key element in connecting monetary and economic activity and in explaining business cycles. There are some models which help to give us clues as to

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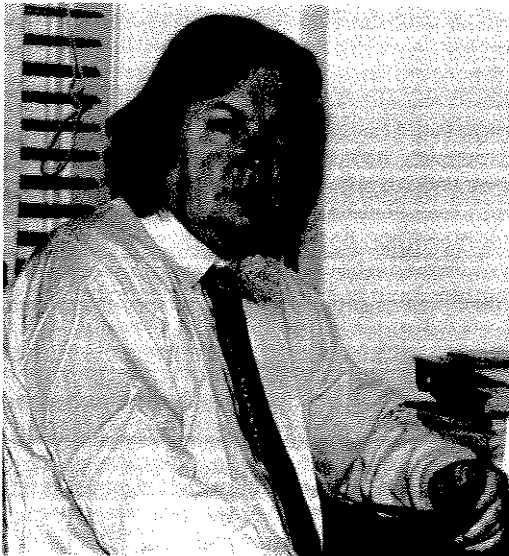
—Robert Mundell

how this process might work, but there's a long way to go.

There is one problem with this and other theories that stress the agent's ignorance of what's happening with the quantity of money. In fact, it's not hard to get information about the quantity of money. If the quantity of money goes up sharply in a month, any regular reader of a major newspaper will know about it. I'm not comfortable with some recent models because they hinge a little too much on ignorance about the money supply. The answer to this problem may be that the relevant concept of money is not well captured by standard aggregates like M_1 .

MR—Dr. Lucas, you seem to be implying that economists haven't come up with a theory that really explains depressions.

Robert Lucas—That's right. Economists like myself or Milton Friedman who attach great importance to changes in the quantity of money in causing a depression have got a hard theoretical problem on our hands. Why should the changes in the quantity of money — basically a units change — alter decisions people make about production, employment, and so forth? That's the great puzzle with business cycle theories. Why doesn't a purely nominal variation in the number of dollars in circulation simply change the general level of prices and nothing else? All the evidence is that some movements of money, in fact, have very disruptive effects. But getting a theoretical model to explain why that should be so has turned out to be a big challenge.



Robert Mundell, Columbia University

MR—Moving now from theory to practice, what, in your opinion, would be the right policy mix to get us out of the current recessionary doldrums?

Robert Mundell—Supply-side tax cuts and monetary policy protective of the value of the dollar is the policy mix we need now. Even if we don't go back to gold this year, we should try to stabilize the international value of the dollar. We should try to reduce unemployment to 5 percent and interest rates to 6 percent. The only program capable of doing that is the supply-side program of stabilizing the price of gold and cutting taxes even more than the Administration has so far managed to do.

Robert Lucas—I think a combination of supply-side economics and tight money is very unfortunate. It will be a shame if that part of monetarist doctrine which is basically accurate should be discredited because it happened to be combined with this tax cut business. The economic rationale for the tax cut just never existed.

MR—Could you go into that?

Robert Lucas—Let me distinguish between two elements which often get lumped under the label of supply-side economics. The idea that taxes have a distorting effect on economic incentives and that it matters which mix of taxes is used to finance a given level of government expenditures is a very old one. Traditional public finance theory has always tried to assess which sorts of tax structures have the least damaging incentive effects. That's what some recent work by Michael Boskin, Martin Feldstein, and others has been about, and this work has advanced the frontiers of public finance quite a bit. We've had a hell of a lot of good work done in that field.

But the idea that cutting taxes generally would stimulate the system enough to increase revenue — which is what I think is the key claim of supply-side economics — doesn't have any foundation whatsoever either in fact or in theory.

Robert Mundell—How much tax cuts will stimulate the system is a matter of degree. If you go back to the period preceding the recession of 1974-75, the budget was close to being balanced. At that time I suggested a large tax cut to offset the negative effect of the high oil prices and to provide the effective supply and demand to prevent a recession. But the Ford-Simon-Greenspan economic team didn't want tax cuts. The upshot was an economic and, for President Ford, a political disaster. We should learn a lesson from the 1974-1975 recession, which



Robert Lucas, *University of Chicago*

brought about the biggest budget deficits in U.S. history.

Anna Schwartz—I think that the supply-side promise was oversold. It was political sweet talk. We must face up to the reality that we cannot spend at our current rate. But raising taxes will not do the trick.

MR—Because of the Laffer effect?

Anna Schwartz—Well, I would say we should not raise taxes in the middle of a recession. I think there is enough economic understanding in this country to know that is not a good idea. There hasn't been any tax cut up until this point. The 5 percent cut in October of '81 was definitely wiped out by the previously scheduled Social Security tax rate increases. There's been, in effect, no real tax cut program up until this point, only a monetary contraction in 1981 and the recession. So we're not merely starting from scratch, we're starting from behind the eight ball.

Robert Lucas—This is closing the barn door after the horse is gone, but I think the tax cut was a mistake. The logic underlying it was nonlogic economically, and it hasn't delivered what it was supposed to deliver. If we can't raise taxes, the next best thing would be to postpone the next two phases of the tax cut.

The deficit is partly due to the recession. Tax receipts are naturally going to fall off during a recession, and there's no reason to change the tax schedule to offset that. But the deficits now

being forecast for the next few years, on through the recovery — they're a problem. Higher taxes at this point would reduce the deficit. That's the missing element right now.

Robert Mundell—Raising taxes now, as the monetarists advocate, would dump us into an even deeper depression than we are now in. Raising taxes by enough to balance the budget now would mean 15 percent unemployment or more, because it would take money away from the businesses that employ people. Unemployed workers don't have any money to spend, and industry won't produce if nobody will spend. Raising taxes now, far from balancing the budget would only leave us with an even larger public debt.

Supply-side theory does not discard the valid Keynesian idea of balancing aggregate demand and supply at full employment, indeed that is a prime feature of our "voodoo" school. But to this basically Keynesian insight we add the idea of using incentives to increase the "marginal efficiency of labor," if I may use that term. We need also to increase the marginal efficiency of capital. The real sinner in our economy is our obsolete tax structure, and raising taxes won't make it any more holy.

MR—You're not concerned about the possible effect of tax cuts on the budget balance?

Robert Mundell—The deficit is high because we're in a great recession and we're not utilizing about \$300 billion dollars of potential output. If there is no output, there are no tax revenues. That's the budget problem in a nutshell. It's too complicated to describe in more detail here, but the budget deficit is caused by an excess of private savings over investment plus the trade deficit. When investment is revived and our trade balance is improved the deficit will disappear. The budget deficit may get a little worse in the short run with tax cuts, but it will get better in the long run.

Robert Lucas—At first there wasn't supposed to be a deficit because the tax cuts were going to be so stimulating!

There are a lot of economists who argue that deficits are irrelevant or almost irrelevant, but I think they're just wrong. A deficit is a promise of a future tax of some sort. It's either a promise of future taxes of the ordinary sort — say, income taxes — or a promise of an inflation tax. Historically, we have paid off the deficits by monetizing the debt, i.e., by an inflation tax. I think that is exactly what people expect will happen again. So do I.

Robert Mundell—In talking of the stimulative

"Now people feel that the budget is uncontrolled, and they are right."

—Anna Schwartz

effects of tax cuts, remember that so far there has not been a tax cut. So far there's only been a 5 percent cut in personal income tax rates. That is too little to even get started. We've had monetary tightening before the tax cuts will be effective and also some tightness on the fiscal side. Those two policies added to the natural momentum of the economy helped create the recession. Economic policy starved the economy of the stimulus it needed to create the production corresponding to full employment.

As a first step — past mistakes are dead considerations — we should bring the 1983 tax cut forward to 1982. The delivery of effective demand-supply is needed now, and the sooner we can get the full tax cuts in operation, the better. I would advocate, in fact, a further tax cut *right now* to give us assurance that we're going to have a revival of the economy in 1982-83, because I think the down-side risk to the economy is very serious at present. I would not like to see the Fed gun the money supply at the present time, because I'm afraid that would decrease confidence in the dollar and put interest rates up rather than bring them down. The present economy of high unemployment and high interest rates caused by inflationary expectations makes for two problems, not one, so you need two instruments to solve them. The problems are inflation and unemployment, and the instruments are monetary and fiscal policy. If we have more expansionary monetary policies now to cope with the recession, we need a gold and exchange rate stabilization agreement to prevent a revival of inflationary expectations.

I think the Administration's economic program should be working better by 1983 and 1984. I hope it will look fine then. I don't think it's going to look all that fine this November. The program was put in so late that the benefits won't show up soon enough. Maybe the President did the best that he could with Congress. I don't know. I won't make excuses one way or the other. The tax cut is the best thing that he's got going for him, but I hope it won't be the only thing going for him. In November people will be asking what happened to the Republican goal of a stable international monetary system? The Gold Commission was a superficial flop, although I give credit to Mrs. Schwartz for collecting a useful compendium of opinions, and generating more interest in the gold standard (despite her monetarist antigold bias) than has ever existed since the Bretton Woods Agreement in 1944. But if President Reagan doesn't have more of an answer on the international issue, or if the dollar is expected to depreciate again, then I think people are going to wonder if they are

that much better off now than they were two years ago, despite the great progress that has been made on the inflationary front.

MR—How can the Fed bring down interest rates?

Anna Schwartz—To bring down interest rates, not only must the rate of growth of money be reduced, but also the public must be convinced that monetary policy will be stable thereafter. We must have credible monetary policy, so that financial markets don't tremble every time the monetary growth rate expands from week to week by some unanticipatedly large figure. I think the enormous public attention on the deficit is probably healthy since there may be more pressure to reduce it, but the deficit is not the focal question on the health of the economy; stable monetary growth is.

Robert Mundell—The monetarists keep changing their definition of money and monetary growth, and give us no clue about monetary policy five years from now. Only a gold and exchange rate agreement can do that. Supply-siders have the only theoretically sound policy for restoring interest rates to levels of the 1950s and 1960s.

The biggest danger right now is that the monetarists will always go on saying, "You are not following our policies" no matter how bad things get. They'll never concede that there is anything wrong with the basic theory. In stopping an inflation there cannot be a steady rate of decline in the rate of monetary expansion because you have to allow for the inevitable decrease in M_1 velocity since with lower inflation and interest rates the public will have more confidence in money and want to hold a higher ratio of money balances to output.

To put a monetarist in charge now of the Fed would bring us another seven years of miserable disaster. That is too much to expect the American public to bear, far beyond the call of even rational expectations. Because many things serve as money, including time deposits, Eurodollars, and even foreign currency balances, we should not want to stabilize any specific monetary aggregate. Even if Volcker does not support the gold standard (as I do) he does at least understand many of the arguments pro and con, better than most of the relevant alternatives to his position. My only misgiving is that he may not want to continue after the expiration of this term.

Monetary policy has to be predictable both in the short and long run. This does not mean a constant money growth based on a variable

(Continued on page 13)

Economic Policies and Interest Rates: Reconciling Supply-Side, Keynesian, and Monetarist Views

David I. Meiselman

In this season of discontent, there is more than usual confusion about, and attribution of, blame for our economic problems. For example, some people who label themselves supply-siders assert that how the world works contradicts the views of monetarists about the central role of the quantity of money in determining inflation and short period changes in business conditions.

From other quarters, we hear that the current business cycle recession is clear evidence of the failure of the supply-side approach in general and of the 1981 tax cuts in particular.

In my judgment, critics of the supply-side analysis and opponents of the Reagan Administration's attempt to shrink the size and role of government have the wrong culprit when they link the current recession to the Administration's fiscal policy. As I shall demonstrate, this criticism is misdirected and stems, in part, either from misinformation or from a hidden agenda.

It would be helpful if I made explicit what I understand the supply-side, the Keynesian, and the monetarist approaches to be. First, supply-side economics asserts that fiscal policy, but especially the tax component of fiscal policy, affects incentives, economic efficiency, and economic growth. Taxes distort relative prices and relative costs. The results are impaired efficiency and retarded growth. Change the rules or change the rewards and you change the results. In brief, most supply-siders believe that the best tax reform is tax reduction.

Keynesians also believe that taxes profoundly affect the economy. But the Keynesian analysis is based on the belief that tax changes, especially changes in income taxes, work by altering aggregate demand. Traditionally, Keynesians have been little concerned with supply. Mired in their (largely erroneous) view of the Great Depression of the 1930s and acting as if they believe that demand creates its own supply, Keynesians have usually displayed little or no concern for problems of output and productivity. Keynesians emphasize what economists label "income effects" resulting from changes in taxes and government spending.

By contrast, supply-siders separate themselves and differentiate their analysis by emphasizing the incentive effects of tax changes, particularly on supply decisions and output. Hence, the title, supply-side economics.

Monetarists, like Keynesians, also focus attention on aggregate demand. Monetarists believe that the *nominal* quantity of money is the major

and the dependable determinant of aggregate demand, or *nominal* GNP. Monetarism is a new label for an old set of analytical and empirical propositions called the quantity theory of money.

According to the quantity theory of money, the stock of money determines aggregate spending. Although government tax and expenditure policies may alter expenditures for individual components of GNP, changes in the component parts of the total have little or no impact on total nominal GNP itself. Consequently, for a given stock of money, which fixes nominal GNP, if there is an increase in government spending, total GNP remains essentially the same, but private spending shrinks to accommodate more government spending. Government spending crowds out private spending.

For monetarists, although nominal GNP is determined by the nominal quantity of money, *in the longrun*, real GNP is determined by *real* factors. In the longrun, the printing press only generates inflation; money cannot produce goods and services. Rather, output depends on supplies of labor, capital, and raw materials, the state of technology, the vigor and resourcefulness of our people, a stable and constructive framework of law and public policy, and so forth, plus the incentives to put these productive resources to efficient use. These are precisely the kinds of real factors that supply-siders, too, emphasize.

Thus, in analyzing supply, I find general agreement between the monetarist and the supply-side approaches. Indeed, monetarists have always emphasized that relative prices, incentives, and so forth—microeconomics—are the essential stuff of real variables, and that the quantity of money in the longrun merely determines the level of prices, not the level of output.

But monetarists clearly distinguish between the longrun, or permanent, effects of monetary change and the shortrun, or temporary, effects of monetary change. Although the printing press can have very little impact on real variables in the longrun, fluctuations in the stock of money are the central and the crucial factor in the short-period fluctuations in output, employment, and profits, usually called the business cycle.

It turns out that changes in the quantity of money first affect real variables—after a lag of something like two quarters. Money alters prices later, much later.

Historically, it has taken about a year before

"The monetary rule I prefer is a fixed quantity of the M_1 measure of money."

—David Meiselman

monetary change affects inflation. After a year, prices start to respond, with a peak effect about seven quarters after the initial change in money. This seven quarter lag is consistent with the current sharp decline in the inflation rate. You may recall that, seven quarters ago, the second quarter of 1980, the money supply collapsed. The rapid expansion of money in the second half of 1980 raises some doubts about the persistence of the current dip in the pace of inflation, especially later in 1982.

A Money Supply Rule: Zero Money Growth

The lags in the effect of money, the incentives for mischief inherent in discretionary policies, and the problems caused by uncertainty about future changes in the stock of money inherent in discretionary monetary policy argue, not only for slow and stable money growth, but slow and stable money growth *mandated by law*.

The monetary rule I prefer is a fixed quantity of the M_1 measure of money. To get from here to there, I propose a gradual 1 percentage point per year decline in the growth of M_1 ; 4 percent in 1982, 3 percent in 1983, and so forth. There would be no more money growth after 1985. By 1985, M_1 would be 10 percent higher than at the end of 1981, or approximately \$484 billion. Zero money growth is approximately consistent with zero inflation, which is why zero money growth is the central part of my proposed rule.

M_1 velocity has been rising approximately 3.5 percent per year, so zero growth is consistent with nominal GNP also increasing at the same 3.5 percent rate. Before the economic slowdown of recent years, output used to increase between 3 percent and 4 percent per year. I see no reason why, once we return to economic health, output cannot return to its earlier trend. Thus, the entire growth of nominal GNP would generally represent a growth in output, not prices. This is why the price level will tend to be stable with a fixed money stock.

After 1985 the rule would be: "No more money, and no less." This clear and simple rule would have many virtues. It would add a most welcome note of certainty to all markets, drive down interest rates *now*, eliminate the inflation, stabilize the economy and prevent government from using inflation as a tax collector. To be sure, variations in velocity or in real economic growth would cause some variability in the price level. However, these changes are bound to be small, especially in comparison to the inflation rollercoaster we have experienced that has been the direct result of fast and variable money growth. In addition, a stable money stock would

eliminate the major source of the business cycle instability of output, employment, and interest rates, and would have inherent price level and interest rate stabilization properties.

A companion rule for fiscal policy would be the proposed balanced budget, expenditure limitation constitutional amendment, which would impose needed spending and fiscal discipline, help to repair serious constitutional flaws, and lessen the bias towards bigger and bigger budgets.

Keynesian Fiscal Policy

Regarding the Keynesian view of fiscal policy, although rigorous research and repeated real world experiments and experiences have demonstrated again and again that the central elements of the Keynesian analysis are simply wrong, Keynesian views still exert a powerful influence on the thinking of many of our citizens, especially those over the age of forty. Nevertheless, the clear evidence is that when allowance is made for the effects of money, changes in government spending, changes in taxes, and changes in the deficit—the aggregate components of fiscal policy—have essentially little or no systematic influence on inflation, the business cycle, or short-period fluctuations in nominal GNP.

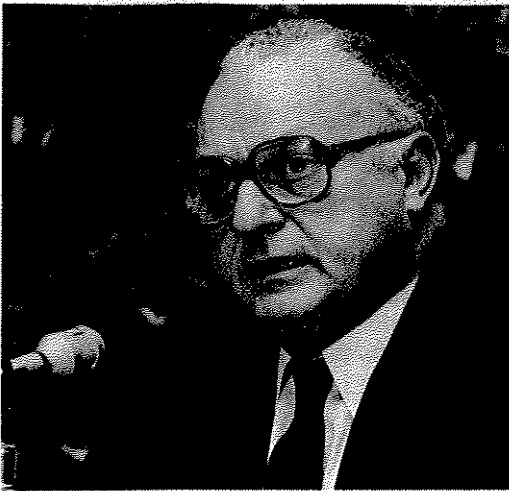
This does not mean that taxes, deficits, or government spending have no effects at all. These influence resource allocation, income distribution, interest rates, efficiency, and growth, but not the business cycle which has been the primary focus of Keynesian attention. This is why there is essentially no tradeoff, as Keynesians contend, between monetary policy and fiscal policy.

In the shortrun, monetary aggregates cause the business cycle. In the shortrun, fiscal policy aggregates have little or no dependable impact on the business cycle. In the longrun, monetary policy has little or no influence on real variables. In the longrun, fiscal policy, by affecting efficiency, growth, income distribution, and incentives, does influence the size and composition of the pie.

Confusing shortrun and longrun effects of monetary and fiscal actions is a major source of the flawed public policies of recent years, unrealistic expectations, and the dashed hopes for easy and quick solutions.

What Does Fiscal Policy Do?

The analysis of fiscal policy is highly complex. Precise, dependable answers may not be cur-



David Meiselman, *Virginia Polytechnic Institute and State University*

Photo by Craig Terry

rently available for many important questions, both because of the complexity of the analysis and the absence of a sufficient body of tested and dependable empirical relationships, for example, between interest rates and saving or investment. These deficiencies in our knowledge argue for humility, and for tentativeness in certain conclusions, not for adhering to the conventional Keynesian and Wall Street analysis that yields answers that are both simple and simply wrong.

To understand what fiscal policy does and does not do, consider separately the components of fiscal policy—expenditures, on the one hand, and the financing of those expenditures, on the other hand.

Government Spending: A Tax

First, for a given stock of money (which determines total spending), government spending tends to replace or crowd out private spending. Government spending for goods and services shifts resources to the public sector. Because government use of resources leaves fewer resources for private sector use, *government spending is itself a tax*. The “expenditure” tax is analytically independent of how expenditures are financed.

The effects of the shift of expenditures depend on the productivity of the public sector use of the resources relative to their productivity in the private sector. However, the low, or negative, productivity of many government programs, itself the result of the general lack of public sector incentives for efficiency plus the vast and costly mechanisms for redistributing income which subsidize consumption, means that, in general, big government results in less aggregate real output. The efficiency losses resulting from governmental spending are inevitably augmented by

additional distortions stemming from *all* methods used to finance expenditures. This is why using government expenditures as a measure of the cost of government understates the total burden and the total cost of the budget.

Financing Government: More Distortions

Each method of financing expenditures adds its own set of additional costs and distortions. If expenditures are financed by taxes, the taxes tend to depress or to alter private sector activities. The effects of taxes on output and on demand depend on the characteristics of the specific taxes involved. No tax is neutral, but some taxes are greater hindrances than others. Because spending in the aggregate depends, not on tax rates, but on the quantity of money, the main impact of the tax structure on aggregate demand is on the composition of spending, not on total spending *per se*.

Deficits and Interest Rates

Expenditures financed by selling government securities (assuming a given stock of money) also end up reallocating resources. Assuming a given demand for Treasury securities, if the Treasury sells more interest-bearing debt, real interest rates rise. Instead of the depressive effects of taxes, we now have the depressive effects of higher real interest rates which reduce interest sensitive expenditures and interest sensitive activities, but also encourage a shift from consumption to saving.

For many public policy issues, the crucial analytical question is whether it is appropriate to assume that the demand for Treasury securities is given and fixed. The disturbance analyzed may well change the demand for securities as well as the supply. For example, the impact on interest rates of raising taxes in order to reduce deficits depends on how the tax increase affects saving and the demand for Treasury securities as well. This is why, in analyzing the impact of tax rate changes on deficits and interest rates, it is simply wrong to consider only the supply of Treasury securities and to neglect demand, as many Wall Street analysts do. Changing tax rates may also affect the demand for securities in general, and perhaps the demand for Treasury securities in particular. In turn, the consequences of a tax change on the demand for securities depends on how the altered taxes affect both saving and the uses to which taxpayers put their assets. In addition, a tax change may affect investment and the private demand for funds. “Revenue enhancements” may lower the recorded deficit, but such tax increases do not necessarily reduce either real or nominal interest rates.

For a given level of expenditure, I do not believe that an *a priori* case can be made that any specific proportion of tax and debt financing is optimal. If the goal is to minimize the cost of distortions caused by both taxes and deficits, then the economic costs of debt financing must be compared to the economic costs of the specific taxes which are levied. The comparison between debt and tax financing depends crucially on which taxes are involved, not on the revenues the taxes happen to generate.

Finally, expenditures can be financed by monetizing the deficit, merely by printing money, non-interest-bearing debt. The increased supply of dollars would cause more inflation and higher nominal interest rates. Moreover, under the present tax code, inflation effectively increases tax rates and imposes a wide range of capital levies.

One conclusion of this discussion is that the complexity of these relationships cannot be captured or understood by reference to the simple numbers on revenues or deficits used to describe budget aggregates, as is the current fashion. It also helps to explain why the usual statistical data on government revenues, taxes, and deficits have little or no historical relationship to inflation, interest rates, or GNP.

One cannot generalize about the effects of budget deficits on interest rates, inflation, and resource allocation because so much depends on how the deficits are financed. Similarly, one cannot generalize about the consequences of eliminating deficits *per se*. It makes a difference whether government expenditures are reduced or taxes are increased. It also makes a difference which expenditures and especially which taxes are altered. Reducing the deficit by cutting government expenditures that have low productivity or subsidize consumption, in my judgment the bulk of the non-defense budget, would tend to lower interest rates and increase output and employment. Balancing the budget by increasing taxes that bear on saving or impair productivity is likely to increase interest rates. Balancing the budget by increasing taxes that fall on investment and capital formation, by reducing returns to capital formation, and by reducing incentives to private borrowing to finance capital outlays, may lead to a decline in interest rates, but at the heavy cost of impaired growth.

Thus, *it does not follow that reducing deficits need lower interest rates*. That depends on which steps are taken to reduce spending or to increase revenues, not on the size of the deficit.

This is why I am so skeptical about stated concerns for the size of the deficit and the presumed

links between deficits and interest rates that omit reference both to the specific measures to eliminate the deficits and to the required analysis of what these budget balancing measures would do. There is even more uncertainty about evaluating the impacts of stated budget deficits because of the peculiar and arbitrary character of government accounting and budgeting procedures and the statistics the current budget process happens to generate.

Keynesians and the Deficit

For many years, Keynesians have had a serious interest in the size of the deficit as a central feature of their analysis of economic fluctuations and of their public policy recommendations. On one level, Keynesian analysis has emphasized short-run business cycle or stabilization goals almost to the exclusion of considering the impacts of taxes, expenditures, and deficits on efficiency and income distribution. On another level, many Keynesians have used legitimate concerns and desires for economic stabilization as convenient rationalizations for their hidden agenda for increasing the size and scope of government and for changing the distribution of income.

Changing the budget deficit is the main tool of Keynesian aggregate demand management and stabilization policy. Because Keynesians believe that higher deficits are systematically and dependably related to increased aggregate demand, Keynesians believe larger deficits help to offset recessions whereas reduced deficits, even surpluses, are required to fight inflation.

Note that applying the Keynesian analysis need not result in more and more government expenditures. It has worked out that way—and not by accident! According to Keynesian doctrine, larger deficits needed to fight recession can be achieved by cutting taxes; more government spending is not necessary. Smaller deficits needed to curb inflation can be reached by reducing government spending rather than raising taxes. Thus, hypothetically, Keynesian doctrine could result in a downward ratcheting of taxes and government expenditures, not the upward ratchet we have observed.

The Hidden Agenda

The biased application of Keynesian theory reflects the inherent biases of both politicians and many of their advisers who use Keynesian tools to achieve their desired goals of big government, high taxes, inflation, and income redistribution.

How else explain the great concern early in
(Continued on back cover)

Idle Resources, Hard Choices

(Continued from page 8)

definition or even a constant growth based on a constant definition. It means a constant process for the public to use effectively the information on hand to make commercial decisions about capital markets and long-term interest rates. Money, as Keynes said, is the link between the past and the future; it is a way of storing liquidity over time; it is also legal tender; it is also the unit of deferred payments. We will only get back to interest rates under 6 percent by stabilizing the world's dominant currency in terms of gold, which is the unit in which the dollar and capital market issues are and should be denominated.

MR—Do deficits affect the interest rate?

Robert Lucas—It's possible, but I think the effect is hard to detect. I can't rule out the possibility of a crowding out effect, but there are just so many forces acting on interest rates that it's a tough job to sort them out. I think the major effect probably has to do with inflationary expectations.

Anna Schwartz—The deficit is bound to affect interest rates, all else being equal, since the federal government is definitely competing for the same savings block as is the private sector. If you increase the demand for funds without increasing the supply — say by an increase in investible savings — then, sure, the interest rate will be affected. We have little evidence on the strength of the effects on interest rates of crowding out versus inflationary expectations. What is certain is that fiscal policy has effects on issues unrelated to interest rates, such as income distribution and resource allocation.

Robert Mundell—Government budget deficits financed by government bond sales are part of the market for loanable funds and of course have an influence on the interest rates in that market in the same way the sale of any other component of the securities market does. So do the budget deficits of households and firms and foreigners when they borrow in that market. But the recession is caused by an excess of private saving over private investment (plus the trade balance deficit) at full employment and that is what caused the budget deficit — a revenues fall and an expenditures increase. Restore the economy to health and the deficits will go away; restore the gold standard and interest rates will come down.

MR—If tomorrow the President announced a very aggressive program to balance the budget in two years — a program of, say, very significant reductions across the board, including defense,

and possibly some tax hikes — what would happen to the interest rate?

Robert Lucas—That depends upon the plausibility of the announcement. If the statement was truly credible, I suspect interest rates would drop, and possibly drop very significantly.

Anna Schwartz—I think that a balanced budget would have a dramatic effect on market psychology. Now people feel the budget is uncontrolled, and they are right. The budget is now caught in a political game. Neither the Republicans nor the Democrats want to be the first to advocate the spending cuts we really need, because they are not politically palatable. Reagan has been especially cautious since he was stung by his Social Security proposal. You don't tell people who have been led to believe that they can retire at sixty-two without penalty that as of September their Social Security benefits will be cut. Now that Reagan has paid that political price, I think he's not going to make any recommendations unless the Democrats do too. Neither party will then be able to make political capital of the other's first step.

MR—How should the budget be balanced?

Robert Mundell—By restoring full employment and getting interest rates down along the lines I have already noted.

Robert Lucas—I don't think there's any support for large-scale cutbacks in Social Security, Medicare, and similar programs. I'm not especially a fan of them, but every advanced country has



Anna Schwartz, National Bureau of Economic Research
Photo by Craig Terry

them, and they seem to be popular. Nor is it clear that now is a good time for us to cut back defense spending. There are certainly some wasteful projects in the defense budget, and everyone will agree wasteful projects should be eliminated. But I doubt whether, on balance, everyone wants to have large-scale cuts in aggregate defense spending.

MR—Is a balanced budget constitutional amendment a long term solution?

Robert Lucas—It's very attractive, but I haven't seen one drafted I can quite picture in the voting booth. They tend to run on for pages and have a lot of qualifications, although most of the qualifications are there for a good reason. I think the idea of formally adopting budget balance in some general sense as a goal of national policy is good, whether or not it can be put in the Constitution. But it is clear with respect to depressions and war that deficit spending serves an important purpose, and any amendment that ruled out our ability to cope with dislocations through deficit spending would be very harmful.

Anna Schwartz—The balanced budget amendment could provide a long-term solution if such a rule truly expressed the will of the electorate. Any rule in a democracy must pass that test.

Robert Mundell—The balanced budget amendment won't work. I think there was once a bill in some state legislature to make pi equal to a round number, three. The balanced budget amendment is like that. The most that could happen would be that Congress would have to juggle around the figures on a piece of paper so that they could fudge estimates to balance the budget on paper. But the reality of a balanced budget cannot be forced.

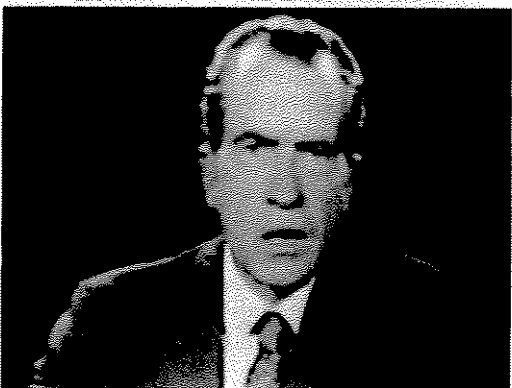
I think it's a good idea for state and local governments to try to balance their budgets, especially when the public debt is at an optimal level. I see no harm in a deficit to finance big capital spending items that will benefit future generations. An unbalanced budget is legitimate if a city needs to buy a new subway system or something like that. But you don't want a balanced budget on the federal level. In the short run it cushions the impact of excessive booms and depression. In a growing economy you have to allow for monetary expansion. We should have a full employment budget deficit at a high level of employment to produce the optimal rate of central bank credit needed to supplement gold imports; that rate depends on the rate of growth of the economy. So even at full employment the budget should not be in exact balance.



Robert Lucas—I think the central problem of the last twelve to fifteen years is the unhinging of our fiscal policy—what James Buchanan and Richard Wagner call the changes in our economic constitution. When Keynesian economics discredited the idea that deficit spending on a sustained basis is a very bad thing, it unhinged the system. I think restoring that discipline would be the key element toward eliminating the inflationary bias of our policies.

MR—Is supply-side economics an economically sound way of dealing with these political problems? Tax cuts have an obvious appeal; they certainly sound better on the six o'clock news than an announcement that it's going to take a depression to end inflation.

Anna Schwartz—If the original Kemp-Roth bill had been enacted and the Fed had accomplished a smoother decline in monetary growth,



We Are All Keynesians Now (clockwise, from top left): **Harry Truman** signing the Full Employment Bill, 1946; **LBJ** enacting a Great Society program, 1967; **Richard Nixon** imposing a wage and price freeze, 1971; **Gerald Ford** wearing a WIN button, 1974.

Wide World Photos

then we would not have had a recession as large as the current one and Reagan might have gotten through this transition period without excessive political cost. An increase in take-home pay and a smoother monetary deceleration might just have accomplished the deflation without much of a recession.

Robert Mundell—For the working, productive part of the population, tax cuts have political appeal. But although the recipients of the redistribution programs probably know that the working people subsidize them, tax cuts are as unpopular among the recipients of benefits as they are popular among those who work. Which of those groups is stronger politically? What we may be getting into is a reorientation of politics with one party or collection of people of both parties representing consumers and another collection of people representing the producers, which would be terribly sinister. But I don't think

the Democratic Party wants to turn its back on the producers completely, and I don't think the Republican Party wants to turn its back on the consumers. Moreover, the interests of producers and consumers are not necessarily in conflict, since producers and consumers are to a large extent the same people. Most of us are both consumers and producers. But if the growing part of the population that is not working, is not self sufficient, and does not have savings becomes pitted against the other group, then I think the production goose that lays the golden consumption eggs could get killed. If there is too much redistribution, too many workers will want to join the lines of welfare recipients or will move away and there won't be tax revenues any longer. I don't have a magic formula to determine what proportion of the total product can be redistributed without rebounding on the size of the total product. It differs in each country. But it is real and supply-side economics has made a useful contribution by making it explicit.

MR—To sum up then, what is your prognosis for the American economy? Can we pull out of our troubles and renew our traditional pattern of growth?

Anna Schwartz—Of course we can pull out of our troubles. To achieve that goal, we need to stabilize the rate of growth of money at a non-inflationary level. If the inflation rate then falls to a 1 or 2 percent annual rate, the economy will get back to its long-term growth pattern.

Robert Lucas—As I've said earlier, the key elements in economic success are stable money growth at around 4 percent per year and a balanced budget fiscal policy. I see no reason for optimism on the second of these goals in the near future, so I am not optimistic that we can sustain the first for much longer, either.

Robert Mundell—I am optimistic we can maintain peace and restore America's position as leader — not dictator — of the Western world if we restore the stability of the global monetary system by linking the dollar to a stabilized gold price. Other reforms we need are a new international institution for restructuring the debts of the third world, abolition of federal income taxes combined with a revenue-replacing value-added tax, and a global agreement to reduce nuclear weapons and other armaments. This program involves a lot of work and negotiation, but it is not beyond the reach of current policy-makers. Strengthening the U.S. economy through a program of economic expansion to meet U.S. commitments at home and abroad has become a matter of top priority. The stakes are high. □

Economic Policies and Interest Rates

(Continued from page 12)

1982 for the scheduled July, 1983 tax reduction and for the indexing of tax rates in 1984, a year and a half away? Why the repeated calls for the elimination of future tax reduction and tax rate indexing now? Why do the Tip O'Neills of the world suddenly express concern about budget deficits, perhaps for the first time in their political lives? Why do we see an absence of the usual Keynesian assertions that budget balance is irrelevant or the mythology of economic cretins and neanderthals? If tax reduction is a spur to economic recovery, as Paul Samuelson, Walter Heller, Jim Tobin, and the other heroes of the Kennedy tax cut certainly believe, shouldn't we hear more about moving forward the 1982 and 1983 tax cuts, and even increasing those tax cuts now to help get the country moving out of the recession? As for the July, 1983 tax cuts, if Keynesians were true to their traditional beliefs, they should argue, as they did in questioning the original program's three year tax reduction package, that we should wait and see what 1983 brings.

The Deficit Hoax

I believe we hear so little about speeding up or enlarging tax cuts and so much about rescinding the 1983 tax cut and the 1984 indexing of the

Federal Tax Code precisely because there is a well understood link between revenues and government spending. Spenders simply want the revenues to maintain or to expand government spending. Spenders want control of more of your income so they can spend it the way they, rather than you, wish. In my judgment, the sudden and novel concern for deficits is a hoax. Understandably, the big spenders are fighting hard to retain the revenue system that depends on the inflation-induced, unlegislated tax rate increases—bracket creep. I may add that many people who supported, and continue to support, tax reduction and indexation of the tax code do so precisely because they believe that restraining revenues is necessary to restrain government spending.

The current recession is, in sum, no reason to abandon efforts at fundamental reform of taxes, spending, and regulation which stem from supply-side considerations.

Indeed, I would hope that the recession and the increasingly unhappy, costly, and unpleasant experience we have had with discretionary monetary policy, would lead to the adoption of a monetary rule that would mandate the slow and steady money growth that is a necessary partner of supply-side tax and budget reductions in restoring the economic health of the nation.

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