Vol. V No. 3 1985

Manhattan Report

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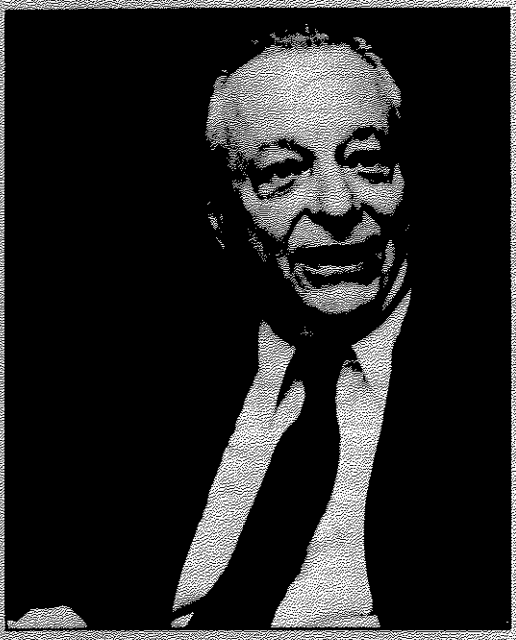

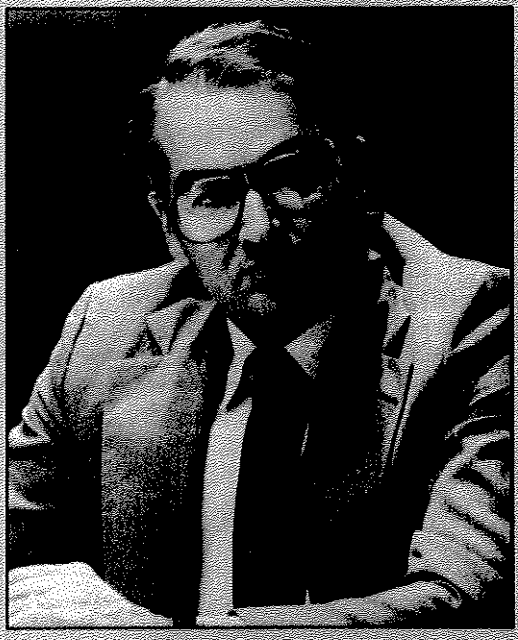

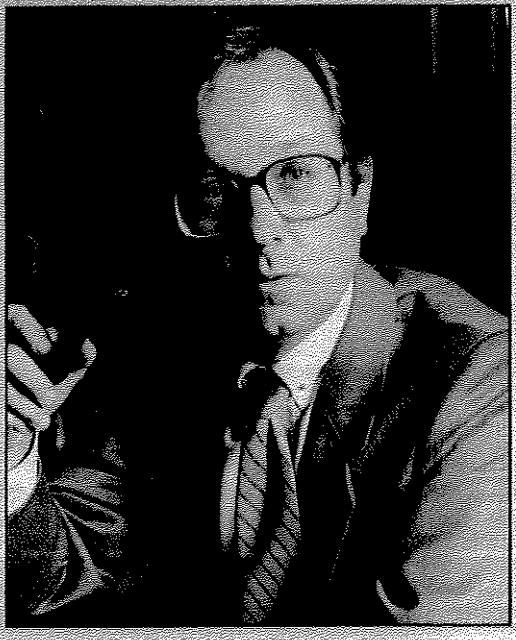

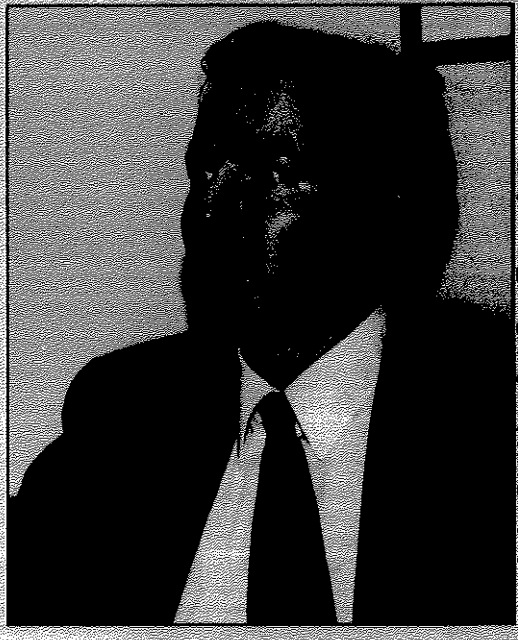

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The World Economy in Perspective

MANHATTAN REPORT

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Cover—Clockwise from Top-Left: Irving Kristol, Jude Wanniski, George Gilder, Alan Reynolds

Editor's Notes

In his book, *The Supply-Side Revolution*, Paul Craig Roberts notes that it was ten years ago when he and a small group of policy advisers surrounding Congressman Jack Kemp set into motion the supply-side ideas that would eventually reshape national economic policymaking. In the decade which has since elapsed, supply-side economics has been at the center of much controversy—with criticism being generated by both liberal and conservative economists.

While the last two years of the recovery have given us strong economic growth, many supply-side critics argue that this was chiefly the result of demand-side pump-priming both by the Federal Reserve and the stimulative effect of large fiscal deficits. Supply-siders respond by pointing to the dramatic drop in inflation in the midst of a booming economy—a phenomenon unexplained by either conventional Keynesian or monetarist analysis.

While the economists continue to debate, the political appeal of supply-side policies has grown beyond the borders of the United States. Socialist governments in India and New Zealand have called for tax cuts to stimulate their ailing economies. The OECD in a recent study has also recommended tax reductions as a way to combat the "Eurosclerosis" which plagues its member nations.

In an interview with George Gilder, author of *Wealth and Poverty* and *The Spirit of Enterprise*, we examine the current state of the U.S. economy and analyze Gilder's arguments as to why our recovery should be credited to supply-side policies.

Following up on these arguments, Alan Reynolds, chief economist for Polyconomics, Inc., makes the case in a second interview that our trade deficit has less to do with Japanese exports than it does with the sluggish, overtaxed economies of Europe and the Third World which have ceased importing U.S. goods.

Finally, a roundtable discussion of prominent journalists takes a look at supply-side ideas and evaluates their relative influence among policy elites around the world. The panelists are: Peter Brimelow, Contributing Editor, *Barron's*: Irving Kristol, Co-Editor, *The Public Interest*; John O'Sullivan, Editorial Page Editor, *New York Post* and Jude Wanniski, President, Polyconomics, Inc. Harvey Segal, an Institute Fellow of the Manhattan Institute served as moderator of the discussion.

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The Spirit of Enterprise
an interview with George Gilder

Eric Meltzer

George Gilder, editorial consultant for the Manhattan Report, *is the author of numerous books and articles. His latest book is* The Spirit of Enterprise, *Simon and Schuster, 1984.*

Manhattan Report—The current U.S. economic expansion has produced greater rates of growth than in any other major industrialized nation over the past few years, yet some people still see the expansion as a classic Keynesian recovery. Is this a Keynesian or a supply-side recovery?

George Gilder—This was the first recovery of the postwar era in which investment grew twice as fast as GNP in the first year. If it were a demand-led Keynesian recovery, the likelihood of that occurring is dim. This was the first truly investment-led recovery we've ever had. From that point of view, I don't think it accords with the Keynesian formula.

Secondly, the OECD countries on average ran bigger governmental budget deficits than we did. If the deficit was the true source of expanded demand that propelled the recovery, why didn't recoveries also occur in Sweden, France, and Italy, with their even bigger deficits? The irony is that we are one of the three countries in the entire OECD group that has actually reduced its national debt as a percentage of GNP. Since 1970, the U.S. national debt has declined slightly as a percentage of GNP. Most of the other countries have increased their national debt substantially. Yet the recovery came in the United States and not in the other OECD countries. It was led by investment and more specifically by venture capital and entrepreneurial investment. That does not accord with the Keynesian pattern which would have seen, among other things, a deficit-led recovery leading to a decline in the value of the currency, a rise in inflationary pressures, a rise in commodity prices, and a rise in the price of gold. All these indices of a demand-led Keynesian recovery were absent. It's just pure fantasy, desperation on the part of the Keynesian economists, to claim that this was a deficit-led recovery. It wasn't. It was a tax-cut-led recovery and it was associated with increased employment, higher productivity, higher real wages, and higher investment levels than in most previous recoveries.

MR—Many of these "desperate" economists are saying that the deficits that got us out of the recession now, in a growth period, are soaking up capital funds and creating the current slowdown in the economy.

Gilder—The slowdown is the result of the boom-and-bust cycle which our economy has pursued. It's very hard for an economy to grow at the tremendous pace which ours has over a two-year period without generating a number of inefficiencies, miscalculations, and excesses. I see this very fully in the leading sector of this recovery, the computer and semiconductor industry. The semiconductor industry, for example, grew 69 percent in two years. This is an industry with hundreds of companies which grew more than two-thirds in 24 months. That kind of convulsive upsurge has now generated a terrible shakeout and collapse, and a huge inventory overhang with many misconceived investment projects.

For nine years, starting with the 1969 capital gains tax increases, we stifled the creation of venture capital and the technological progress that flows from it. Then suddenly we let off the restrictions by cutting the capital gains tax, first in 1978, and then again in 1981, along with personal income tax rates. That combination produced a 60 percent increase in the number of companies listed over the counter in the stock market, a 200-fold increase in venture capital commitments, and a doubling of new business starts. This whole array of tremendous responses unfortunately encouraged the problems that we're currently experiencing, the malinvestment and misjudged monetary policies that have slowed growth.

MR—In your book, *The Spirit of Enterprise*, you compared the current shakeout in the computer industry to the auto industry at the turn of the century.
Gilder—In 1908, there were twenty serious entries in the automobile field. Henry Ford, incidentally, was not among the top twenty at the time. It was a period of tremendous innovation and experimentation but it was also a period of consolidation. By 1914, the auto market was down to seven or eight companies. It was a very difficult and painful transition for many participants in the automobile industry, particularly the advocates of steam and electric propulsion, which were still considered feasible until about 1910. There is a similar phase of consolidation under way in the computer industry today. However, I think that computers are a more diverse product line than automobiles, so the consolidation will not reduce the industry to four major companies the way the consolidation in automobiles eventuated. There are all sorts of activities in the computer industry that assure a very vibrant and multifarious business with lots of companies. In fact, recent technological and manufacturing advances—in supercomputing, in parallel and vector processing, and in solid state memory—promise greater gains in computer functions and declines in cost than ever before. The industry is on the brink of an exciting resurgence for the rest of the decade. And most of the breakthroughs are coming from relatively small firms, such as Cray and Elxsi, start-ups such as Micron, and restarts such as Atari, rather than from IBM and Hitachi.
MR—Statistics are showing a renewed decline in American productivity. You have made the case that we consistently mismeasure productivity.
Gilder—The numbers are almost meaningless. They're completely cyclical numbers. It's because we've employed a large number of people and then we had a pause in GNP growth. Those two big macro-numbers are joined to signify a decline in national productivity. But we're better off having all these people employed than not having them employed. They're learning and they're becoming more productive. Meanwhile, in a crucial source of productive growth, the application of new technology, we're leading the world—a fact which almost entirely eludes the statisticians of gross national product. Their models assume that for the last twenty years computer prices have remained essentially flat, while in fact they continue to drop dramatically. Joel Popkin, who used to keep these figures for the Carter Administration, estimated a $150 billion understatement of GNP for 1983 as a result of the miscalculation in computer prices alone. Computers embody the essential technologies of the information age. The fact that statisticians can't measure the value of computers means that they can't measure any of the devices that use computers and that are similar in their technological sophistication. The general assumption of the economist is that prices rise unless it can be proven otherwise. All of these new technologies are characterized by rapidly dropping prices and rapidly increasing functional efficiencies. These are not measured at all well. Since they are the most rapidly growing domain of the economy, it means that economists aren't measuring the true productivity achievements of the United States. We've employed seven million additional people in the last two years while the Europeans have created no new jobs in the same time period. I guess they're having faster productivity growth.
MR—What do you think are the basic factors behind that disparity? Great Britain has experienced something of a mild recovery, yet its unemployment figures remain incredibly high.
Gilder—The key factor is that economic growth is chiefly entrepreneurial. New companies grow faster than old companies. They employ more people and they create more jobs. In the United States, since 1978, there has been a great entrepreneurial revival. It's been reported widely; it's manifested in the statistics; and it's very evident in the overall aggregate performance of the economy. That is the crux of the better performance.

Immigration has also been a great help to the United States. Europeans have been paying their immigrants to go home on the assumption that immigrants take jobs. That's a false model. We've had twelve million legal or illegal aliens come to the United States over the last decade, creating jobs and opportunities through their productive efforts.

The deregulatory movement has also helped, touching everything from finance, to transportation, to communications—the central nervous system of the national economy. We've had an open economy and we've benefited from it.
MR—How do you respond to people like Bob Kuttner who say that the problem is that most of these new jobs are low-paying service jobs and what we're seeing is the vanishing of the middle class?
Gilder—That's what people have been saying for some time. They really want it to happen—a glorious return of the proletariat. The figures just don't confirm that proposition. If you account for new entries into the work force and changing age patterns, there isn't any evidence of a vanishing middle class. Moreover, in this recovery, there has not only been a dramatic increase in the number of jobs, there have also been dramatic increases in productivity and real wages. We're seeing jobs increasing in quality rather than declining. There's no evidence that jobs repairing or selling computers are inferior to jobs in a steel mill. This idea that there's something noble and special about jobs in a steel mill reflects Marxian symbolism more than anything else. People like Bob Kuttner are just nostalgic toward the old remnant of the proletariat

"The real problem is the collapse of imports in Europe and the Third World rather than the export performance of the Japanese." —George Gilder

Change in World Imports 1980-1984 In U.S. Dollars

High-Tax Countries		Low-Tax Countries	
Sweden	−40%	United States	+41%
Netherlands	−35	Malaysia	+41
Belgium	−19	South Korea	+39
Italy	−28	Turkey	+33
Denmark	−29	Hong Kong	+31
France	−48	China	+23
Norway	−34	Canada	+23
Germany	−30	Singapore	+17
United Kingdom	−17	Bahrain	+12
Greece	−39	Thailand	+ 9
Ireland	−26	Japan	− 5

Source: Alan Reynolds, Polyconomics, Inc.

that is disappearing before their eyes without ever having exhibited a gesture of revolutionary behavior.

MR—We've already established that you don't believe the budget deficit is slowing down the economy. What about the trade deficit?

Gilder—The argument that the trade deficit has cost us two million jobs conflicts with the fact that the countries with trade deficits, particularly the United States, have been creating jobs twice as fast as the countries with trade surpluses, including Japan. When I look at specific industries, I find that the trade deficit is beneficial to the United States. The computer revolution, which has taken off more in the United States than anywhere else, was indispensably aided by huge flows of microchips from Japan. The personal computer surge was a $50 billion industry that arose over only three years in the United States. Nobody expected it to rise so fast nor could they supply the demands for components which it created. The American computer industry could not have obtained enough memory chips for IBM personal computers without the aid of Hitachi, Fujitsu, Oki, and other Japanese companies. And if these orders hadn't been filled, then the computers couldn't have been sold, and the kind of effect that they had on our economy would have been lost.

The cause of this trade deficit is not a technological lag on the part of the United States but rather our technological lead in software. Five thousand new software firms have cropped up over the last four or five years, and they've essentially industrialized software. This unexpected entrepreneurial efflorescence did not occur in Europe or Japan. As a result, we've been applying computer technology much more rapidly than either of them—50 percent faster, and from a base of much higher computer usage in 1980. We've been able to apply the new hardware much more rapidly because we've had this tremendous entrepreneurial surge in the creation of software which transforms the computer from a deaf-and-dumb machine into a useful instrument of productivity. So the high-tech deficit in the balance of payments is attributable to our software lead rather than any hardware lag. In turn, our high technology investment and application has been central to our whole economic recovery, and it could not have happened without this balance-of-trade deficit with Japan in high technology goods.

In any case, much of the examination of the trade deficit has been misconceived because it's focused on Japan and Asia. Asia collectively has substantially increased its imports over the last four years while Europe has reduced its imports over 30 percent. Latin America has reduced its imports 60 percent; Africa has reduced its imports 25 percent; these economies collectively dwarf the impact of Japanese economic activity. The real problem is the collapse of imports in Europe and the Third World rather than the export performance of the Japanese, who provide us with very attractive products that increase the real value of earnings in the United States. The collapse of imports has come about because of increasing bracket creep in European tax rates, and a combination of bracket creep and austerity programs in Latin America that have stagnated those economies. The problem is not the strong dollar, it's the weak mark, and pound, and franc. These countries have to revive their economies with reductions in their marginal tax rates. It's the only thing they can do. It would be nice if they could cut back on government spending, but it's not going to happen. Their only hope is to expand the

(continued on page 19)

Tax Cuts and Growth: A Global Survey
an interview with Alan Reynolds

Alan Reynolds is vice president and chief economist for Polyconomics, Inc. in Morristown, New Jersey. He is the author of a recent paper "The Urgency of International Tax Relief."

Manhattan Report—Paul Volcker has recently recommended that the major European nations cut taxes as a way of stimulating their economies and thus help to correct some of the current trade imbalances we now see among the industrialized countries. Do you favor this approach?

Alan Reynolds—It's one approach we can take. The European countries, are facing, on average, marginal tax rates of around 65 percent on relatively moderate incomes—$25,000 to $30,000. In many cases, that average obscures rates that are really 70 to 80 percent or higher. This isn't the kind of environment where you can expect entrepreneurship to flourish.

These tax rates have made it very difficult for the Europeans to escape economic stagnation which has, in turn, created a number of fiscal and exchange rate problems. The lack of economic growth has created chronic budgetary deficits. At the same time, the Europeans are experiencing exchange rate difficulties due to capital flight. Because of the oppressive tax structure, Europeans don't want to invest in European economies, and neither do Americans.

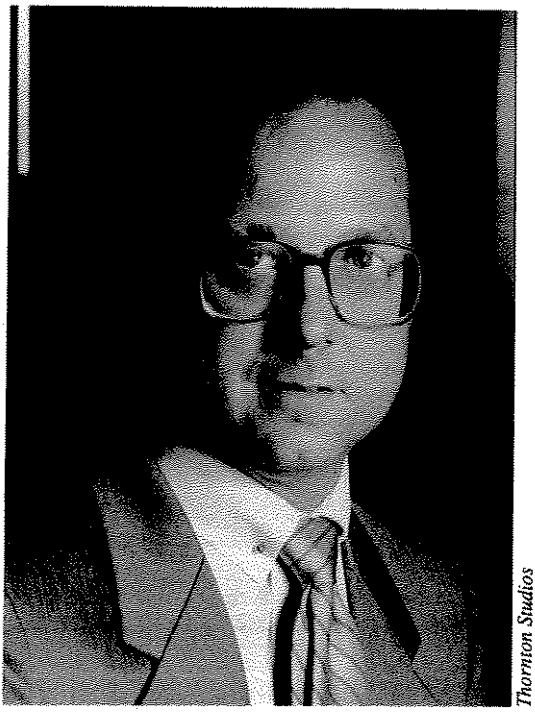
MR—How extensive is this high-tax problem?

Reynolds—The high-tax countries in Europe have certain characteristics in common. They all virtually have dropped out of world trade on the import side, with imports down 30 to 50 percent since 1980. Their economies are stagnating, so they don't need to import capital equipment or commodities. For a decade or more, these countries have experienced declining capital formation. Gross investment—plant, equipment, and housing—has fallen anywhere from 1 to 3 percent a year for a decade in overtaxed countries like Belgium, the Netherlands, Denmark, and Sweden.

They have also faced declining labor force participation rates among men. This trend is not prevalent among women, but it's important to remember that women, for the most part, are new entrants, in lower tax brackets, and aren't yet as affected by high marginal disincentives to work. Still, you basically have a situation where people are not only not employed, but also where they don't care to *be* employed. When you have a reduction of the quantity and quality of both labor and capital, you can't really expect to have an increase in output.

MR—Is the trade imbalance caused by these overtaxed economies, or is it more a monetary phenomenon of the overvalued dollar?

Reynolds—It's both, in the sense that world trade has been shrinking. The U.S. share of world trade outside our borders has actually risen since 1980.



Thornton Studios

Alan Reynolds, *Polyconomics, Inc.*

Unfortunately, it's a larger share of a smaller market. There are two dimensions to shrinking trade: One is price, and the other is volume. The price part is a monetary phenomenon, an overvalued dollar resulting from an overly tight Fed policy. The rising dollar has dropped the prices of internationally traded goods and that, of course, reduces the *dollar* volume of trade.

But the *real* volume of trade is also down because of these overtaxed European economies, which have dropped out of world trade. These economies are stagnant. Their only economic growth comes from two sources: either growth in government consumption, or growth in exports to the United States, neither of which raises living standards. They're subsidizing the building of Saabs and Volvos and sending them over here, but that's not really making their own people any better off.

When you look at those countries where import volume has risen, it's those countries that we usually think of as exporters, notably Hong Kong, Singapore, Malaysia, South Korea, and of course, the United States. These are all countries that have reduced their tax rates recently and, as a result, are prospering. They are importing more *and* exporting more.

MR—You emphasize that growth in imports is a sign of economic health. Yet with the economy slowing down, many economists are saying that imports are hurting the recovery.

Reynolds—That analysis is based on some rather basic fallacies. One is that the gap between invest-

ment and savings in the U.S. supposedly determines the capital inflow, and therefore the trade deficit. But it's just the other way around. It's people's decisions about where they want to invest, namely in the United States, that causes investment here to exceed domestic savings. That's not a bad thing. We don't have to be concerned about the fact that Americans aren't investing in Japan but that the Japanese are investing billions in Silicon Valley or Austin, Texas. If that process goes on much longer, Japan will deindustrialize and the United States will be the industrial capital of the world. We're not simply importing financial capital. We're importing physical capital—real machines—and we're producing them here as well. Up until the deliberate Fed squeeze of last summer, U.S. industrial production was the fastest growing in the world. You can't argue that we aren't competitive and simultaneously observe that our industrial production is outstripping other developed countries.

Also, I think it's misleading to put all the blame for the trade deficit on the strong dollar. We ran a trade deficit with Japan when the dollar was weak and now we're running a deficit with Japan while the dollar is strong. The British pound has virtually collapsed, and yet I don't see people rushing to buy Austins and MGs in the United States. That model just doesn't work. A rising dollar can cause some problems just as a falling dollar can cause the opposite problems. The problems of a rising dollar have to do primarily with a decline in prices. It's a deflation problem rather than a trade volume problem *per se*. American farms, mills, and mines can't *afford* to export when prices drop below cost.

MR—Are you saying that although the trade imbalance reflects some bad policies on the part of European countries, it's not necessarily a bad thing for the U.S.?

Reynolds—You have to start with the arithmetic that world exports can't exceed world imports. Many countries are trying to export more than they import and somebody has to be left holding the bag. Primarily, it has been the relatively prosperous countries that are importing goods and capital equipment to help their economies expand. These also happen to be low-tax countries. Both their own citizens and foreign citizens want to invest in these countries. This, in turn, creates exchange rate imbalances that exacerbate the trade deficit and induce even more economic stagnation in high-tax countries. When high-tax countries experience outflows of capital, they have to keep their interest rates high through a tight monetary policy to prevent their currencies from collapsing. Basically, you can bolster your currency in two ways. You can adopt a more liberal tax policy—lowering marginal tax rates—or you can run a tight monetary policy. Either approach will hold up your currency.

If, like Great Britain, you lead people to believe that you're about to cut taxes and then *don't*, you can expect a weakening currency, which did occur in early 1984. That leads you to raise interest rates, as the British Central Bank was compelled to do by 350 basis points as a way of keeping the currency from collapsing. They ended up with the worst of all worlds. They have the relative economic stagnation caused by high tax rates, plus the super-high interest rates needed to prevent capital from flowing out of the country, plus accelerating inflation from the drop in the pound.

MR—According to that chain of events, the Democrats in Congress are right. If they raise taxes, they'll get the weaker dollar that they're after.

Reynolds—Yes, indeed. And if you raise taxes high enough, you'll induce a recession which will reduce imports dramatically. I guess in that model, the reduction of imports would bring prosperity, but that's not correct.

MR—You've indicated a very strong connection between growth rates and taxation, where high-tax countries have experienced below-par economic growth while low-tax countries have done remarkably well. How do we know that this correlation isn't merely a reflection of other factors, such as greater government spending or intervention that are the real culprits in hindering growth?

Reynolds—I'm not monotheistic. There are, in the particular model that I'm using, two major factors at work. One is the stability of the currency. For small, open economies, the question becomes "Do you peg your currency to something credible or do you let it float?" The other factor is "How high do you set marginal tax rates and at what level of income do they apply?" It is true, of course, that government regulation and spending cause problems of their own. The embarrassing reality, though, is that the most rapid growth in government spending occurs in the low-tax countries. The annual growth of real government consumption in places like Hong Kong, Singapore, Thailand, Malaysia, Botswana, and Indonesia averages anywhere from 7 to 13 percent a year. It hasn't always been growing as a share of GNP, because the private sector is growing even more rapidly. But government spending has been growing very rapidly in absolute real terms in supply-side countries, including Japan, so it can hardly be the cause of economic stagnation. Conversely, where you have chronic overtaxation, the private economy slumps and the government simply runs out of resources. Austerity eventually affects the government sector as well as the private sector. The United Kingdom has been a case in point. Government was not growing rapidly in the United Kingdom—less than 1 percent a year from 1976 to 1982—it's just that nothing else was either. In Israel, real government consumption *fell* by 2 percent a year from 1976 to 1982.

MR—You have written that, in 1983, 40 percent of

"...it's fascinating that so many economists are reluctant to concede that in extreme cases, it is possible to tax an economy into perpetual decline." —Alan Reynolds

Comparative Performances Of Low-Tax And High-Tax Countries Real Average Annual Growth Rates 1970-79

Country	Per Capita Income US Dollars 1979	Gross Domestic Product	Public Consumption	Private Consumption
Thailand (low-tax)	500-600	7.7	9.1	6.9
Zambia (high-tax)		1.5	1.8	−2.2
Paraguay (low-tax)	700-1100	8.3	4.8	7.4
Peru (high-tax)		3.1	6.5	2.9
Mauritius (low-tax)	1100-1300	8.2	13.5	9.8
Jamaica (high-tax)		−0.9	8.0	−0.6
South Korea (low-tax)	1400-1700	10.3	8.7	8.0
Chile (high-tax)		1.9	−0.5	1.9
Brazil (low-tax)	1700-2100	8.7	8.6	9.1
Uruguay (high-tax)		2.5	1.5	0
Singapore (low-tax)	3800-5950	8.4	6.4	7.2
New Zealand (high-tax)		2.4	–	–
Spain (low-tax)	4300-6350	4.4	5.6	4.4
United Kingdom (high-tax)		2.1	2.8	1.7
Japan (low-tax)	8800-11,950	5.2	5.0	5.3
Sweden (high-tax)		2.0	3.2	2.0

Source: Keith Marsden, World Bank

the world's developing countries had economic growth rates of below zero. Can tax policy really have a major effect in that area of the world, considering all the other economic problems those countries face?

Reynolds—All economic models or theories have merit at least in the extreme case. If you're in a severe depression, then Keynes can be useful. If you're in a hyperinflation, Milton Friedman has something to tell you. That's why it's fascinating that so many economists are reluctant to concede that in extreme cases, it is possible to tax an economy into perpetual decline. I think of the example of Jamaica where in ten years per capita GNP has fallen 38 percent. This is a country that had low living standards to begin with. Jamaica has a top marginal tax rate of 57.5 percent that kicks in at $2,500 a year. In Jamaica, if you make $1,200 a year or less, you can get free food. If you make $1,300, you lose the free food and start to move into a tax structure that hits 57.5 percent by the time you're making $2,500. In that type of situation, you'll think very carefully before you earn, or at least report, any income above $1,200. If you're capable of earning income above $2,500, you'll probably leave the country. One-third of Jamaica's professional and managerial class have exported their human capital in recent years.

Throughout the world, this story can be told over and over again. There are the good guys, however. There are the Singapores, Indonesias, South Koreas, Botswanas, and Egypts that keep cutting their tax rates and raising the income levels at which those tax rates apply. The People's Republic of China has a very low marginal tax rate on agriculture—zero. India just slashed tax rates again. Wherever this approach has been tried, it has never failed to work. Where the opposite has occurred, namely, punitive tax rates at low incomes relative to the country's per capita income, it has never failed to produce serious, chronic, perpetual economic decline.

MR—How do you handle the argument that the causality is in the other direction—countries that are growing can afford to cut taxes while poor countries that aren't generating any growth, necessarily have to raise taxes to support their starving public sector?

Reynolds—The sad irony is that of the twenty poorest countries for which I have data, the individual income tax, on average, accounts for only 7 percent of total government revenues. Clearly, these high marginal rates are not raising revenue. People then argue, "If they don't raise any revenue, why are income taxes a problem?" They're a problem because of the process by which people

have to adjust their lives in order to avoid paying these punitive marginal tax rates of 50 to 60 percent at incomes which sometimes range anywhere from $5 to $5,000 a year. You have to hide your economic activities, keep no books, fail to advertise, decentralize, operate out of your basement, or simply withdraw from productive activity altogether. That is a very successful method for evading taxation, but it also creates poverty.

MR—You indicated that cutting taxes aids growth. Yet in many Third World countries, governments are churning over because of dismal records of economic failure. Why don't more politicians embrace this policy? What could be more popular than cutting taxes and increasing economic growth?

Reynolds—It's partly the classic confusion between marginal tax rates and average tax rates. It's quite possible to reduce marginal tax rates without affecting the average tax rate or total revenues. The tax reform being proposed in the United States is revenue neutral, yet it tends to reduce marginal federal-state tax rates after 1986.

A more prevalent problem in the less developed countries is that they may not be free to reduce their marginal tax rates because of International Monetary Fund supervision. The IMF treats symptoms rather than looking at fundamental causes. They go into a country that is economically prostrate and they observe budget deficits, so they indirectly endorse raising taxes. They go into another country where the currency is suspect, and capital is leaving the country, so they observe a balance of payments deficit. The remedy, in addition to tariffs, is usually to devalue the currency, which of course accelerates the capital flight. It also compounds the tax problem because it causes inflation, which, in turn, quickly pushes more and more people into the higher tax brackets—"bracket gallop." If you're going to propose devaluation of the currency in a country that doesn't have an indexed tax structure, you should, at least, also propose adjusting the income thresholds at which marginal rates apply. Otherwise, you're essentially proposing that they destroy themselves economically as well as politically. Recent examples would include Jamaica with its riots; the Sudan, where the IMF's advice was not taken too well by the public; and more recently, the Philippines. Once the developing countries fall under the yolk of the IMF, they find that those loans are very costly indeed.

MR—What should the IMF be doing?

Reynolds—Look at what the League of Nations did with the hyper-inflation countries of Eastern Europe in the 1920s. The League went to Austria and Hungary and said, "The first thing you have to do is stabilize your currency." If the IMF had been in a similar situation, they would have said, "The first thing you have to do is destabilize your currency, i.e. let it float." For most of these countries, letting their currencies float would be like going to Rhode Island and saying, "Why don't you create your own dollar, and let it float against the U.S. dollar and see who wants to hold it?" The answer is nobody wants to hold it.

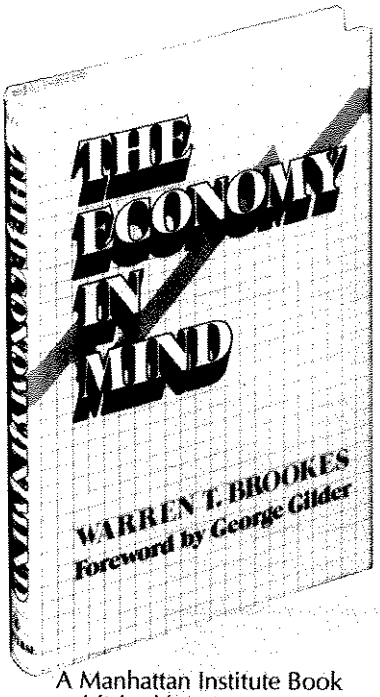
When this advice was taken in the Philippines, the national peso immediately dropped 65 percent and inflation climbed to 50 percent—meaning that marginal tax rates were cutting in at half the real income level that they were before. Real output fell by 5.5 percent in one year, the first postwar decline in output ever recorded in the Philippines. These effects are strong and instantaneous.

The IMF should have recommended pegging the currency against a stronger currency or commodity standard. The second thing is that if you are going through a long period of inflation, even if you want to keep tax rates high for egalitarian reasons, you should at least adjust tax thresholds so that high tax rates apply at reasonable incomes relative to a society's capacity to produce. It isn't much of a problem to have a 50 percent tax rate at an income of $200,000 in a developing country, because no one earns $200,000 in a developing country.

MR—If supply-side policies, in cutting tax rates at the upper end of the income scale, are perceived as being inegalitarian, is there any reason to believe that they would fly any better than the IMF reforms?

Reynolds—That's why I stress the importance of the thresholds rather than the rates themselves. In a country like Israel, for example, you hit a 60 percent marginal tax rate at about $13,000 (not to mention consumption taxes that can go up to 800 percent). The trouble is, the egalitarian ethic is now applying at such modest incomes that it just doesn't make sense. If Israel wanted to have some sort of punitive tax at extremely high incomes, they could forego the services of people who are capable of earning those high incomes, collect the $300 exit tax as skilled people left, and still carry on. What they can't live without is a productive, motivated middle class, and that's what their high tax policy is pushing them towards. The perception that higher thresholds are inegalitarian or that they benefit the rich is usually quite wrong. It has to do, again, with the confusion between marginal and average tax rates. It's quite possible to get the average rate up, the marginal rate down, and collect more revenue from a larger number of rising incomes. Indeed, that simply tends to happen. By reducing the tax on each additional dollar, creative people are likely to earn and report more income, and therefore end up paying more taxes. They don't mind sharing 30 percent of an extra dollar, but they go through a great deal of effort to avoid sharing 50, 60, or 70 percent of an extra dollar. Until Israel and other countries learn that lesson, they'll continue to operate in a vicious policy circle of economic decline. □

From the Manhattan Instit
Four Books That Are Shaping A



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Warren T. Brookes

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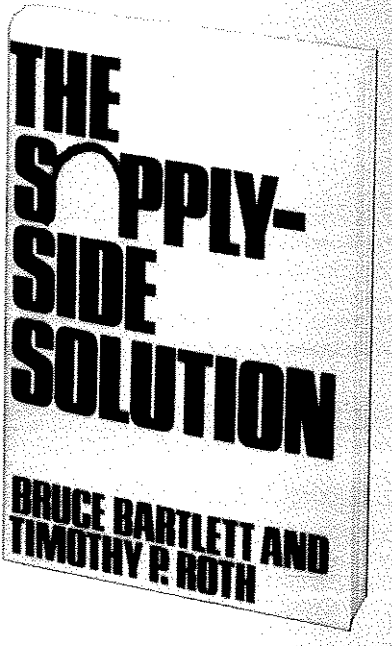

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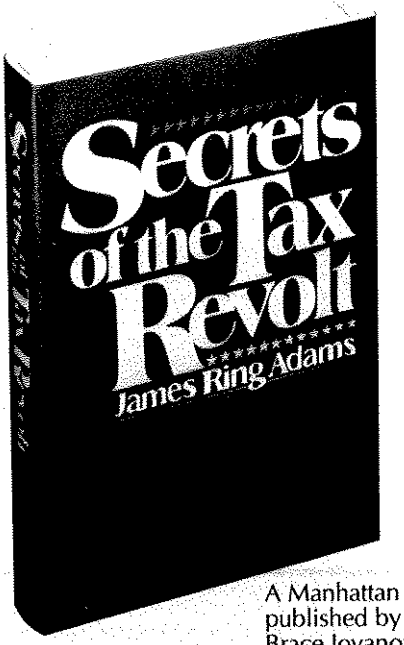

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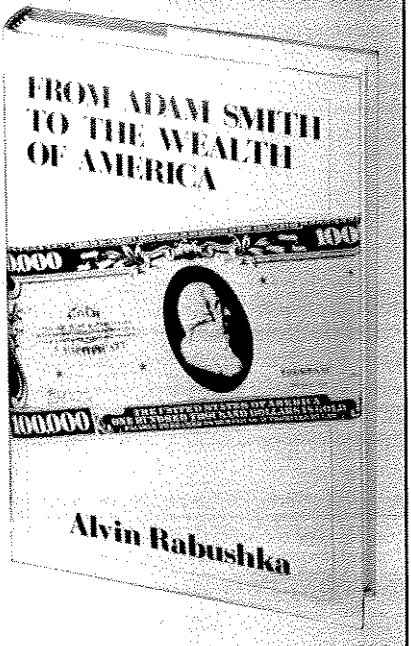
"...the President should send a copy of this book to every member of Congress, especially to all those "Thatcherite" Republicans who – like columnist George Will – keep muttering about 'traditional fiscal conservatism' and tight money."

– Warren Brookes
The Detroit News



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Transaction Books (1985)
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Supply-Side And The Role Of Ideas: A Roundtable Discussion

Participants

Peter Brimelow, *Barron's*
Irving Kristol, *The Public Interest*
John O'Sullivan, *New York Post*
Jude Wanniski, *Polyconomics, Inc.*

Moderator: Harvey Segal, Institute Fellow, Manhattan Institute

Harvey Segal—In 1980, George Bush characterized supply-side theories as "voodoo economics." To what extent has that conventional attitude been reversed? Is the current recovery generally perceived as a supply-side phenomenon?

Jude Wanniski—I think it is generally seen as a supply-side recovery. The critics of supply-side economics, however, say that it is a recovery that is bound to fail in the end. They believe that we will have to pay for these deficits. I noticed that Mario Cuomo at a recent Columbia University banquet honoring Walter Wriston spent a great deal of his time denouncing supply-side economics. Yet he ended up recalling to the audience his days as lieutenant governor when he entered Hugh Carey's office with a copy of my book,* saying "Look, this is how you've been running New York State all along."

On the one hand, you have strong attacks made on supply-side economics. On the other hand, there is this deep concern that the Republicans are getting credit for what Democrats have been doing all along. Tom Wicker has argued in his *New York Times* column that Walter Mondale should have embraced the Bradley-Gephardt Tax Reform instead of allowing the Republicans to capture the growth issue. Bill Bradley now characterizes himself as a moderate supply-sider.

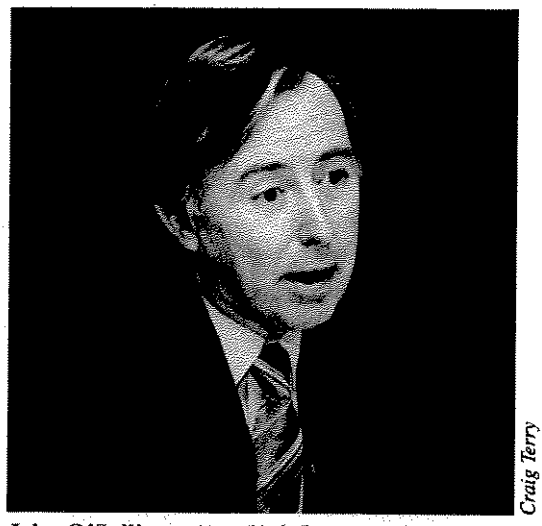
Peter Brimelow—But in general terms, I don't think liberal Democrats would concede that supply-side economics works. They still tend to view it as "voodoo economics."

Wanniski—The term "supply-side" is still an anathema. The ideas themselves, though, have been integrated into the public consciousness to the point where policymakers and politicians are surprised at how many of the tenets of incentive economics they have come to accept.

When Republican Mary Mochary ran against Bill Bradley in the 1984 Senate race, she reviewed video tapes of Jeff Bell's 1978 race against Bradley. Jeff's was the first real supply-side campaign in the country. She told me how astonished she was at how many of Jeff Bell's arguments she accepted, whereas six years ago she thought they were nonsense.

John O'Sullivan—I think you may be overly optimistic. There has been a change in attitude among politicians and, to some extent, in the press. But if you go to the major universities, I think you will still find that economists regard the recovery as having resulted from a traditional Keynesian deficit stimulus. The supply-side analysis is simply not accepted, and often not even recognized.

**The Way The World Works*, Basic Books, 1978



Craig Terry

John O'Sullivan, *New York Post*

Irving Kristol—Ordinary people judge policies by results, so ordinary people accept supply-side economics. This, in turn, has had an effect on politicians, as well as on political rhetoric. Incentive economics, to some degree, is replacing egalitarian economics in national political debate. But John is quite right. In the universities, all the Keynesians go around proclaiming that this is a normal Keynesian recovery, even though they never predicted it. Not only did they not predict it, they argued that the opposite would occur. Paul Samuelson, among others, warned of runaway inflation.

Moreover, the financial community also continues to hold rather orthodox economic views, whether they be monetarist, Keynesian, or just plain Hooverite. They don't accept supply-side ideas. They regard the recovery as very fragile, perhaps transient. They're making money like bandits, but they don't quite believe it.

Wanniski—I think Wall Street is divided down the middle on this. All the economists oppose supply-side economics. Yet all the portfolio managers, who have seen the power of these ideas in generating bull markets, accept supply-side economics.

Kristol—Except they don't accept the theory. They accept the results happily, but essentially they echo their economists. They keep worrying about the deficits.

Brimelow—It does seem to me there is a danger of the credit for the recovery being hijacked by Keynesians. We should bear in the mind the example of the Great Depression. The Great Depression was very largely exacerbated, if not indeed caused, by activities of the government, which was at the same time claiming credit for building up a social

"...all the Keynesians go around proclaiming that this is a normal Keynesian recovery, even though they never predicted it." —Irving Kristol

Keynesian Predictions About The Kemp-Roth Tax Cuts

"Two-digit price inflation is a distinct possibility for much of the decade."
—Paul Samuelson
Newsweek December 15, 1980

"If Keynesians are correct that tax cuts increase demand by much more than they raise supply, a mammoth $120 billion tax cut (even if spread over three years) could produce an inflationary outburst that would dwarf anything we have seen up to now."
—Gardner Ackley
Dun's Business Month August, 1978

"A $114 billion tax cut in three years would simply overwhelm our existing productive capacity with a tidal wave of demand and sweep away all hope of curbing deficits and containing inflation. Indeed, it would soon generate roaring deficits and roaring inflation."
—Walter Heller
The Wall Street Journal July 12, 1978

welfare network to save people from the horrors of laissez-faire. It's a very disturbing example of the power of professional ideologists to shape public perceptions.

Wanniski—I'm not so much concerned with who gets credit for the recovery as I am with political power. If the Democrats fool themselves into thinking that it was a Keynesian recovery, then they will run on that platform in 1988. Our candidates will run on supply-side ideas and we will swamp them again, and continue to swamp them until they not only adopt our policies but adopt the message as well.

Kristol—I cannot emphasize too strongly the relationship between Keynesian economics and the egalitarian impulse. The special interests that control the Democratic Party are not really interested in growth. They are interested in redistribution. The political appeal of Keynesian economics was the argument that redistribution would create economic growth. I think they are stuck with that thesis.

Segal—We now have had three quarters of subpar real growth. What impact do you think that is going to have on the acceptance of supply-side ideas?

Kristol—I don't think it will have any. The three quarters of slow growth resulted from an overly tight monetary policy on the part of the Federal Reserve. Now the Fed has brought down interest rates and the budget looks as if it will be cut. I think we are going to enter a boom, particularly if the Tax Reform Act goes through. We would then have the lowest marginal rates of any major industrialized economy in the world.

O'Sullivan—I don't think anyone ever said that supply-side economics could abolish the trade cycle. There will continue to be fluctuations but there may be some reaction to the attempt of some politicians to oversell supply-side economics as completely painless.

Kristol—Look, the slowdown was caused by the strong dollar and we know what is causing that—the central bank is not providing enough dollars to meet world demand.

Segal—Do you think the Fed should follow a kind of Ronald McKinnon rule and increase the growth of the money stock any time the dollar strengthens relative to the other major currencies of the world?

Kristol—That is one rule they should follow. The Fed, like any individual or corporation in a free economy, has to cope with markets. If the market keeps pushing up the price of your products, what do you do? Produce more of it. So I think the Fed should look at the McKinnon rule. At the same time, the Fed also has the obligation to try to get interest rates as low as possible. If, at a certain point, the long-term bond market starts reacting negatively to a decline in interest rates, for fear of inflation, then the Fed should stop and take stock. But barring a return to some form of commodity standard, the Fed has no alternative but to look at the markets it deals in and see how they respond.

Wanniski—In the last few months, there's been a growing consensus in Washington that the floating exchange rate system has broken down. Both *The Wall Street Journal* and *The New York Times* editorially support a movement towards stable exchange rates. The problem with Ronald McKinnon is that he is proposing the creation of a paper snake whereby the United States would link up with the European currency system. The European system only works because it has an outside reference point—namely the U.S. dollar—which, on a daily basis, permits central bankers in Europe to solve the problem of who is going to tighten and who is going to ease. If the U.S. joins together with Europe and Japan in one big paper snake, what objective standard will enable us to make those decisions? We need to look at some external commodity standard—the price of gold or the price of a basket

"In a modern mass democracy, the gold standard imposes an unacceptable level of economic discipline." —Irving Kristol

of commodities.

Kristol—I don't see a return to the gold standard. In a modern mass democracy, the gold standard imposes an unacceptable level of economic discipline. Politicians just won't accept it. I can see us linking the dollar to the European currency system which could then be linked to some commodity index. Now that, I think, is feasible. That idea does not arouse the tremendous hostility that the gold standard does among politicians, perhaps because politicians don't understand it very well. It would, in fact, put considerable restraint on the political process. And so long as they don't understand that, I think they would probably go along with it.

O'Sullivan—I don't believe for a moment that floating rates are on their way out. Let me illustrate: In 1931, when the British Government decided to let the pound float, an exasperated Lord Passfield (Sidney Webb), a minister in the previous Labor government which had fallen because of the financial crisis, was heard to remark: "No one told us we could do that!" Once you've discredited the idea that a politician has to obey an external rule, it's very difficult to restore it. It would require enormous international upheavals. The sacrifices that politicians imposed on their electorates in the 1950s and 1960s in order to maintain parity under the Bretton-Woods System they're not able to call for now, because they know they can be avoided by floating. I think it would be very difficult to put that genie back in the bottle.

Kristol—I think you might get the genie back in the bottle if the politicians didn't quite understand that that's what they were doing.

O'Sullivan—Which, in a way, is what happened with Bretton Woods. But that came at the end of the Second World War in an atmosphere of optimism enormously different from the rather world weary one that prevails today.

Segal—Why haven't supply-side ideas made more progress in some of the European countries that have conservative governments?

O'Sullivan—It depends on what you mean by supply-side policies. It's perfectly true that, to take the case of England, a strong supply-side tax policy has not been pursued. In fact, the reverse is true—taxes have been increased. Generally speaking, policy has concentrated much more on sound money than on incentives. However, there is another definition of supply-side, which is to say the removal of obstacles to supply. In the last thirty years, up to 1979, Britain has erected an enormous number of obstacles to efficient supply and the Thatcher government has been tackling a number of them. The most dramatic example is in the policy of privatizing state industries. British Telecom and British Gas have just gone on the market. British Airways will be sold next year. These are enormous enterprises which have sometimes drawn large subsidies from

Bettmann Newsphotos

A Protest Against Bretton Woods, 1945
Above left a woman is chained to a fellow protestor dressed as a banking magnate. The heavy "golden chain" represents the burden of the gold standard.

the public sector. So in this broad sense of the term supply-side, there has been an attempt to reform the British economy. On the tax side that hasn't been the case. I don't offer any deep, mysterious, cultural reasons for this. Basically, Margaret Thatcher, Nigel Lawson, and Geoffrey Howe* simply don't believe that supply-side economics adds up.

Kristol—To the best of my knowledge, not a single British economist of any note, in either academia or the financial community favors supply-side economics. Margaret Thatcher is just not getting any such advice. Nor is there any leading member of Parliament in the Conservative Party playing the role of Jack Kemp.

Brimelow—In Canada, a supply-side revolution, of sorts, did take place. In the early 1970s, the Canadians indexed their income tax system and also introduced a number of measures similar to IRA accounts which were designed to stimulate saving. For example in Canada, the first $1,000 of interest income that you make is tax free. Plus, if you are a Canadian there are all sorts of nationalist measures which enable you to avoid taxes by investing or saving through Canadian corporate and financial entities. The effects have been quite dramatic. The saving rate has risen from an historic rate of 4 percent in the 1940s and 1950s to a recent rate of 12 percent. Moreover, I think Jude is partly correct in his book, *The Way The World Works*, when he argues that it was because the income tax system was indexed that Canadians did not suffer as severe a recession in the mid-1970s as did the U.S. Yet all of

*Nigel Lawson and Geoffrey Howe are Margaret Thatcher's current and former Ministers of the Exchequer, respectively.

"I have come to believe that elite establishments around the world are opposed to economic growth and new entrepreneurial activity." —Jude Wanniski

this was done without any conscious acknowledgment of supply-side arguments. In fact, if you talk to the economic intellectuals in Canada they will still tell you that supply-side theory is voodoo economics.

Kristol—I think that in the case of Canada one has to make the statement that supply-side economics is not necessarily going to work in a small country that is part of the world economy if the world economy is going bad. Nothing will work in that situation.

Brimelow—Well, Irving, my point is that it did work.

Kristol—It worked temporarily; but in the end the Canadian economy goes the way of the American economy. If the major economic powers follow the wrong policies, they will simply export their damage to the other countries.

O'Sullivan—That hasn't been true of Hong Kong. Hong Kong took a tremendous beating for about two years after the oil price shock of 1974. Then it made a spectacular recovery because of the remarkable flexibility of its economy. Very often, small open-market economies adjust astonishingly well under adverse circumstances as compared to larger economic units, such as Great Britain, where it is possible to avoid adjustments for much longer periods of time, which of course, builds up trouble.

Wanniski—I have come to believe that elite establishments around the world are opposed to economic growth and new entrepreneurial activity. It's almost new money versus old money. I recall Margaret Thatcher in 1979 running as a supply-sider. The London stock market was booming upon her victory and then went into a nose dive as she became surrounded by bankers from the City of London urging her to offset personal income tax cuts with a huge increase in the value-added tax. The same thing occurred in Canada when Joe Clark ran as a supply-sider, practically quoting Kempian ideas, and winning a great victory over Trudeau. In the days after that victory, I was in contact with officials of the Conservative Party in Canada who complained to me that the bankers in Montreal and Toronto had swooped down upon Clark and advised him that he could not do what he had promised the people of Canada. Elites throughout the world resist these ideas because they are revolutionary and ultimately will spawn new economic growth that older political and cultural interests resent.

Kristol—You have to make a distinction between political elites and economic elites, even though the results are the same. The entrenched political elites of the Third World really don't desire entrepreneurial-driven economic growth because it would weaken their power and authority. The entrenched economic elites in the developed countries, on the other hand, simply don't believe in supply-side analysis. About a year ago at the Council of Foreign Relations, I had a brief conversation with Raymond Barre, who is now the leading conservative political figure in France. He was attacking supply-side economics at which I got up and said, "Why in God's name are you attacking us; why don't you just emulate us?" Afterwards, he took me aside and said, "We can't emulate you. If we were to cut tax rates and incur a deficit, the franc would collapse." I asked him, "When had a currency ever collapsed from a cut in tax rates?" He just brushed that aside. In fact, I don't know of a single such historical instance. Barre is a conventional economist, a banker's economist. While he may be good in other areas, he's very negative on tax cuts. I worry about what will happen in France even if Mitterand loses the next election.

Segal—What about tax cuts in European countries that have had social welfare programs for a considerable time? I was recently looking at figures on Belgium's economy. They have a huge deficit as a percentage of their GNP. Moreover, unlike the U.S., a very large part of it is financed by monetization. Now, if you cut the tax rates in that situation and don't cut spending, aren't you in trouble?

Craig Terry

Peter Brimelow, *Barron's*

Wanniski—Not in Belgium. Not in most of the other European countries either. Their personal income tax produces only a very small proportion of their total revenue precisely because the rates are so high. Belgium has a top tax rate of 76 percent at around $60,000. The average tax rates in Europe, because they have not been adjusted for inflation in over a decade, are now around 65 percent, encountered at incomes of $25,000 to $30,000 and 50 percent tax rates that fall on people with incomes of anywhere from $12,000 in Italy and the Netherlands to $15,000 to $20,000 elsewhere—yet the revenues are very low. Most of the European countries get their revenues from the value-added tax. In England the top tax rate is 60 percent encountered at around $40,000. The 50 percent rate is encoun-

"A 3 percent growth rate year after year is not impressive if you're starting from a collapse in the industrial economy." —Jude Wanniski

Individual Tax Rates And Economic Growth In The Major OECD Nations*

Countries	Maximum Individual Tax Rate 1984	Income Threshold U.S. Dollars	Real Gross Domestic Product (GDP) Growth Rate 1980-83
Sweden	82%	25,300	1.0
Netherlands	72%	61,400	−0.3
Belgium	76%	63,000	0.9
Italy	81%	257,900	0.6
Denmark	73%	22,200	1.2
France	65%	31,900	1.0
Norway	64%	33,900	2.4
Germany	56%	41,200	0.5
Luxembourg	60%	55,000	1.3
United Kingdom	60%	41,700	0.5
Austria	62%	67,900	1.5
Canada	49-60%	44,800	1.0
Finland	51%	61,600	3.3
Switzerland	33-46%	151,000	1.4
United States	50-66%	162,400	1.0
Japan	70%	317,400	3.8

*Organization for Economic Cooperation and Development

Source: Alan Reynolds, Polyconomics, Inc.

tered around $20,000. The *Financial Times* of London estimates that to cut the top tax rate in Britain from 60 percent to 30 percent would only cost $1.5 billion in lost revenue—a trivial amount! It's obvious to even non-supply-siders that the high tax rates in Europe are unproductive sources of revenue as well as barriers to commerce and production.

O'Sullivan—The problem of welfare is an enormous one in Western Europe. To begin with, there's Powell's Law which states, "It is more blessed not to take away than to give." Once some benefit is in place, it is almost impossible to remove it. And without economic growth, it is very difficult to make it more profitable for a worker to actually go to work when he loses benefits by doing so. Secondly, politics is a reactive business. The number of governments which come in with a clear idea of what they want to do and how to implement it, is really quite small. Most of the time, they deal with the problems thrust upon them. Now in regard to Great Britain, you have to realize that the Thatcher government was faced with certain decisions on trade union laws and slimming down state corporations which were presented to it by the situation, and they more or less made the right decisions.

Kristol—Mrs. Thatcher has done a lot of good things and she certainly inherited a situation far more difficult than Ronald Reagan's. Still, after six years in office, to have unemployment at 13 percent is intolerable. That is political failure.

O'Sullivan—I'm beginning to wonder if unemployment is one of those topics which is more an elite issue than a mass issue. Once unemployment does not result in serious personal hardship, it becomes less of a political problem. A large number of the unemployed in Great Britain combine state benefits with part-time work.

Segal—Off the books?

O'Sullivan—Off the books, untaxed, and a lifestyle that emphasizes, "Work when you wish to work, don't, when you don't." I don't think that a 13 percent rate of unemployment is a failure if it is the result of labor unions pricing people out of jobs, and this is, in turn, accepted by the unemployed as well as the members of those unions.

Wanniski—If the people of England are happy with a 13 percent unemployment rate, then they will re-elect Margaret Thatcher no matter who her opposition is. But I think it is a tragedy that the potential of the people of England is not being realized under policies that ignore the oppressive effects of personal income tax rates in smothering incentives and economic growth.

O'Sullivan—We've had a very robust rate of growth in England over the last four years—roughly 3 percent.

Wanniski—In the Great Depression we had the highest growth rates ever experienced in this century—11-12 percent real growth rates. That's because if you start production at 100 and drop it to 50, you can have 10 percent growth rates for a number of years and not get back to where you started. A 3 percent growth rate year after year is not impressive if you're starting from a collapse in the industrial economy.

O'Sullivan—If you're saying that we started from

a low base, that's perfectly true. That's why we have a high unemployment rate. We've also got, however, a consistently high productivity rate. We've got a low rate of inflation, and the only figure that you're able to point out as being a serious drawback is the rate of unemployment. That figure is itself a misleading one in my view, and it certainly doesn't represent severe human hardship.

Kristol—I think we can agree that Margaret Thatcher has been doing everything right within the limits of her power except in the area of tax rates. But I think the point that was raised about government spending has to be addressed. A government, at some point, does have to cut spending if it wants a healthy economy. The difficult question is "when?" I think it is somewhat easier to cut when times are good, and that is the only way I can see to cope with the problem of government spending. If you have an irresponsible government, it can spend you into bankruptcy with the best supply-side economics in the world.

Segal—If politics in a democracy is a market for political power, the politicians are supposed to be professional marketmakers. Why are they resisting supply-side ideas? Is there a lag in their perceptions? How do you see the relationship between new ideas and the political process?

Kristol—Old ideas strongly entrenched are very tenacious. People who have believed and expounded those ideas for 30 years don't just turn around and give them up. There is a war of ideas going on. You must remember that even though Keynesian economics captured the American academy in the 1930s and 1940s, no President dared say he was a Keynesian until Richard Nixon. That's a 30-year lag.

O'Sullivan—I'm beginning to wonder if there isn't something you might call the John the Baptist effect—followed by the Savior effect. In all the countries I can think of, someone has come along at a very early stage to point out the decay of a particular set of social and economic ideas—in Britain's case, Social Democracy. Two good examples would be Barry Goldwater in the U.S. and Edward Heath in England. They point out what's wrong but since the effects of bad policies are not yet really painful, they lose, or abandon their principles in the face of opposition. Then the seeds of decay begin to develop and things get painful. The conventional wisdom is seen to have failed and the electorate turns to the other set of ideas which have been articulated in opposition to the prevailing wisdom. Therein comes the Savior effect—Reagan and Thatcher.

Wanniski—All world political leaders need to establish some sort of consensus from their cabinets or with the elite establishment. There are very few places in the world now where a leader can simply dictate policy—even the Politburo. The problem there is that they have to achieve *too much* consensus. As a result of achieving consensus, they wind up being incrementalist at a time when bold action is needed. When you want to do something and you ask for advisers, they're all looking for ways where it would fail.

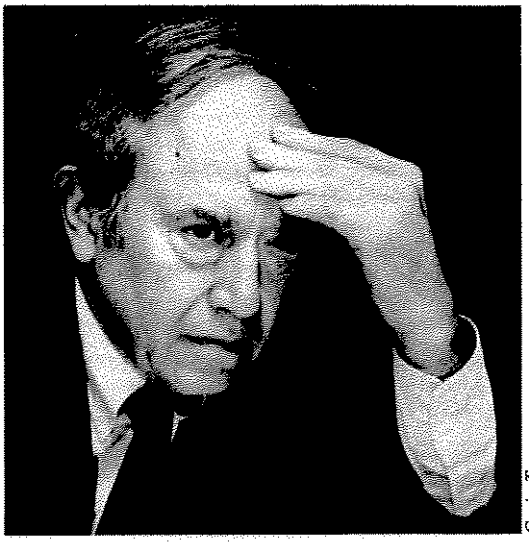
John Kennedy was confronted with a group of advisers in the early 1960s who told him that he couldn't cut tax rates. He went to Germany and he met with Ludwig Ehrhardt who had been cutting tax rates like mad. Ehrhardt told Kennedy a 91 percent tax rate was too high and that he should bring tax rates down. So at that time, it was the Germans who were advising *us* to cut taxes. I recommended to Deputy Treasury Secretary, Richard Darman, that we take this message back to Helmut Kohl. We should say, "You got our economy going back in the early 1960s by recommending tax cuts. We want to do the same for you now."

Kristol—I think we have to recognize the degree to which the application of supply-side economics in the U.S. was an accident. It was a stroke of good luck that Ronald Reagan was persuaded of the efficacy of supply-side economics. If Gerald Ford or Bob Dole had been the candidate, it never would have happened.

Wanniski—Reagan studied economics from 1928 to 1932 when supply-side economics was all that was taught. Furthermore, Reagan observed first hand and he writes about it in his autobiography, *Where's the Rest of Me?,* the destruction of the movie industry in the 1940s as the result of high marginal income tax rates. Thus we have a situation where the leading champions of supply-side economics are now a former movie actor (Reagan), a former football player (Kemp), and a former basketball player (Bradley), all of whom confronted extremely high tax rates at the peak of their careers which forced them to do very uneconomic things with their resources.

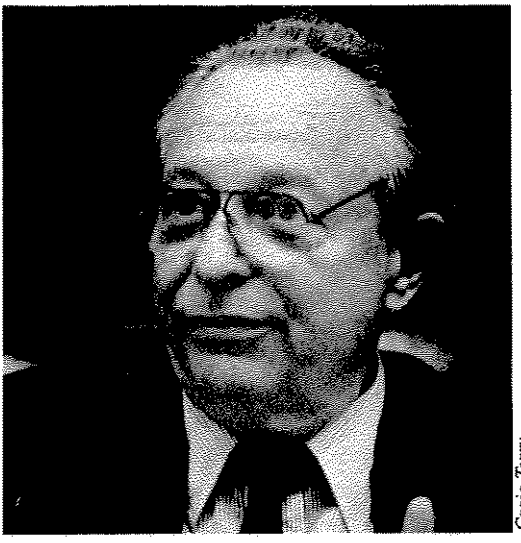
Brimelow—I don't think it's just Reagan. The great asset of this country is that a complex and vigorous conservative movement has developed over the past 30 years. There is really no parallel to it in any other country. Consequently when Reagan came into power, there were a fair number of people who were well-versed in the facts of supply and demand. That's really what supply-side economics is all about. By contrast, those of us who went to college in the 1960s and 1970s, were explicitly taught that government could and should organize things.

Segal—Getting back to the point about the resistance to new ideas, I was writing editorials for *The Washington Post* at the time of the Kennedy tax cut, and there was enormous congressional opposition. As a matter of fact, my own opinion is that it was really Phil Graham who persuaded Jack Kennedy. He went on to the yacht, and he said in effect, "Mr. President, if taxes aren't cut here, it will be the end



Craig Terry

"Are you opposed to the IMF coming in and imposing a money growth ceiling?"
—Harvey Segal



Craig Terry

"I'm opposed to the IMF existing."
—Irving Kristol

of Western civilization."

Kristol—That's always a good line.

Wanniski—I think that an upcoming debate that pertains to supply-side theory will be one that focuses on the policy of the International Monetary Fund in relationship to less-developed countries. The issue is, "If we are going to aid the Third-World countries, are we going to require them to raise taxes or are we going to ask them to reform their tax structures and increase incentives?" If we go the incentive route, I think we'll see supply-side ideas having a greater impact throughout the world.

O'Sullivan—Are you suggesting that we move to a situation in which the U.S. and other Western countries give money unconditionally? One of the dangers that I can see is that those countries will simply spend the money on subsidized industries and economic handouts.

Wanniski—Right now we give them money on the condition that they induce a recession in their economy. I'm saying we should give them money if they induce an expansion in their economy, through lower taxes and a fixed, convertible currency.

Kristol—Now it is true that some of these governments can screw up any economy. They can print money endlessly. But even governments with strong economic self-discipline can't do much without some economic growth. And yet we keep prescribing economic austerity for these countries.

Segal—Are you opposed to the IMF coming in and imposing a money growth ceiling?

Kristol—I'm opposed to the IMF existing. It serves no purpose. We can do more with bilateral aid than we can with the IMF, which will always be controlled by the bankers.

O'Sullivan—What about tariffs in relationship to developing countries? Tariffs are themselves a tax. Shouldn't people who believe in supply-side economics be agitating for even greater free trade *in the interests of the country which cuts its tariffs?*

Kristol—You can't ask countries suffering from terrible economic conditions and whose industries are barely able to survive to cut tariffs. That can only come about as a result of economic expansion. Then they might consider cutting tariffs.

Wanniski—Supply-siders believe in free trade. But that doesn't mean we favor zero tariffs anymore than we would favor no tax. Tax revenues have to be raised.

Brimelow—Jude, what's your view on the trade-off between taxes and tariffs?

Wanniski—I think I would prefer now to reduce the top marginal rate on personal income to 25 percent, and if that required raising tariffs by $15 billion to make up the revenue, I'd support it. The revenue raising capacity of tariffs (because they are often fixed rates) has been eroded by inflation. A small tariff increase would not be that harmful.

O'Sullivan—At the turn of the century, conservative advocates of the British welfare state favored tariffs over taxes on the grounds that here was a way of financing welfare expenditures without egalitarianism. The tariff was considered a non-egalitarian tax.

Segal—What do you think is the future of supply-side ideas?

Kristol—The basic rule of politics is that you can't beat a horse with no horse. Ronald Reagan has a horse and his opponents don't have a horse. And he's winning. In Europe, neither side has a horse, so they're both losing. If the British and the Ger-

"In 1930, if you polled the 6,000 economists in the United States...they would have described themselves as supply-side economists." —Jude Wanniski

man electorates had a chance to vote for "none of the above," that would be the majority party.

Wanniski—In 1930, if you polled the 6,000 economists in the United States (and if the term had existed), they would have described themselves as supply-side economists. Because they were unable to explain the crash of 1929 and the Great Depression, a great intellectual vacuum occurred and demand management economics came into vogue. It reached its high watermark in the 1960s and began to fade in the 1970s when it could no longer cope with international economic conditions. Supply-side theory is now experiencing a revival, reinvigorated by Robert Mundell at Columbia and his student Art Laffer. It also found a political champion, Ronald Reagan. I would suggest that by the end of the century supply-side theory will dominate economic thinking worldwide. Forty or fifty years from now, conditions will occur that supply-side theory can't explain and demand theory will reemerge. This is the cycle we've been on for many years, and I think it will persist.

Brimelow—Alvin Rabushka's book, *From Adam Smith to the Wealth of Nations** is an excellent summary of how supply-side ideas gained ascendancy in nineteenth-century England. I think he is quite right to draw a parallel between that era, and the current situation in the United States and the rest of the world. It seems quite likely that supply-side ideas will continue to predominate. How effectively they predominate, and who gets the credit for it, depends to a large extent on people like Jude and Irving trumpeting its successes very loudly.

O'Sullivan—In 1982, mid-term elections were held in the middle of a severe economic recession. The Reagan Republicans did not do as badly as precedent suggested. That tells me that there has been a very substantial underlying change of opinion within the electorate which isn't just dependent upon the ups and downs of the economy. Even if our optimistic predictions about the future of the American economy turn out to be wrong, I don't see a mass return to Keynesianism. We now have a much more incentivist, inegalitarian outlook on economic questions, and that will continue. But I think it's unwise of supply-siders to restrict the term "supply-side" just to tax policies. It embraces a much wider range of issues, and when we look at it in those terms, I think we do see that it is a world movement. Certainly it has the same staying power as socialism had in 1870, and it is just as likely to shape our political future. □

an interview with George Gilder

(continued from page 5)

private economy faster than the public economy.

MR—President Reagan seems to be the only major world political figure who has accepted the notion that taxes and marginal rates matter. How would you evaluate his current proposal for tax reform?

Gilder—I think it's a good initiative and will probably be improved in the Congress. From time to time, people have been saying that Reagan isn't really a supply-sider. Yet even during the worst period in his administration, during the 1982 recession, Reagan's position was "I'll contemplate some kinds of tax hikes, as long as you don't touch indexing or marginal rates." He could not have reached that position without having started from some sort of supply-side premise. That was the real test.

With regard to the current tax reform proposal, I wish the Republicans weren't so afraid of being called the "rich man's party." That's the reason why they can't reduce the top rate enough so that New York doesn't get conniptions if it loses the state and local deduction. They also should not double the personal exemption. They should double the dependent exemption for children but not the personal exemption. That could save $22 billion in static revenues and allow them to reduce marginal rates to the point where even high-tax states would get a significant tax cut. Children are not affected by marginal tax rates so it's logical to give families a big dependent exemption for them. Individuals, on the other hand, are affected by marginal rates so there's no reason to double their exemption. They benefit from dropping the marginal rates.

MR—You mentioned the concern of the Republicans about being identified as the rich man's party. How has supply-side economics benefited working class and low-income Americans?

Gilder—This supply-side recovery has operated in line with supply-side theory which maintains that cuts in tax rates reduce inflationary pressures rather than increase them. There were some Keynesians who predicted a recovery, but none of them predicted a strong recovery with declining inflation rates. It was only the supply-siders who said, "If you cut tax rates, inflation rates will fall rapidly." So what the average American got was a job at a rising real pay. This tremendous success in job creation also helped poor Americans, chiefly the huge number of immigrants who have come to the United States. Unfortunately, the welfare state insulates the inner city from the benefits of the expanding economy to some extent. Female-headed families that are a large portion of that population don't benefit as much as other people. That's why the next major step on the agenda should be to reform this welfare monster that is destroying families at such a pace. *(continued on back cover)*

*See page 10.

an interview with George Gilder

(continued from page 19)

MR—What about the relative impact of the tax proposal on business versus individuals?

Gilder—The reform will help all businesses and it will help them the most through lower personal income tax rates. If the personal rates are high and the business rates are low, it will hurt business. We've had a lot of experience in Europe with all sorts of special favors, subsidies, and rapid write-offs being granted to business. Their economies still remain sluggish because of high marginal personal tax rates. By allowing personal rates to rise or remain at destructive levels you stifle growth regardless of what sort of benefits you offer enterprises. In general, it doesn't work to provide subsidies for equipment to make cars while punishing the purchase of cars. It's the same contradiction with investment tax credits and consumption taxes. You subsidize the production of consumer goods and hinder their consumption. It just doesn't work. Particularly since consumer demand reflects the productivity of workers. In general, real income can't exceed output. What really produces demand is additional productive efforts on the part of the broad range of citizens and those productive efforts are best summoned by lower personal rates. Those lower personal rates will expand supply and demand simultaneously and thus stimulate economic growth.

MR—You're not worried that there is a shift to corporate taxes that's going to be overly burdensome on the corporate sector?

Gilder—I don't think there will be any shift toward corporate taxes and I think real investment will increase, not decline. If they cut the highest personal marginal rate to 30 percent and tax the corporate sector at higher effective rates than now, there will still be a shift towards individual taxpayers paying a greater share of total taxes. It's happened every time we've significantly cut marginal tax rates in the past. Whenever the highest rates have been reduced, the wealthy have ended up paying a higher share of total tax revenues. Revenues move toward the portions of the tax code with the declining rates. If personal rates drop more than corporate rates, the personal sector will continue to increase its share of the total. Behavioral changes dominate everything else. I've been involved with a lot of small businesses over the last few years. You should see how these small businesses radically transform their whole institutional nature and behavior in response to tax changes, not to mention the big corporations that perpetually merge, divide, and reorganize in response to the tax code.

MR—Do you have any impressions about the supply-side revolution in relationship to the cultural changes that have been taking place, the attitudes of young people towards entrepreneurship and going into business?

Gilder—Supply-side policies create opportunities. Opportunities summon initiatives. Initiatives develop character and a sense of responsibility, a feeling of optimism. Those spiritual results were summoned by the practical policies of supply-side economics. I think that there has been a real relationship between the changes in tax and regulatory policy and the attitudes of students toward business. The future looks more open and promising to them than it did before, for the simple reason that it *is* more open and promising. We've had a doubling of business starts in the last seven years. There has been a riot of new technologies and small software firms, many of which were started by high school dropouts, beginning with computer games and proceeding on to ambitious data base packages. There's been a convergence of policy and technology that has changed the spirit of America. □

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