

Beware: Economic Theories

By Amitai Etzioni

The medicine the Reagan Administration is preparing for the body-economy consists of vast overdoses of two medications, two which are incompatible to boot. It may well be one more illustration of the well-established medical principle that what is therapeutic in an appropriate amount may be poisonous in an overdose. Excessively tight monetary policy will push the country into a second recession while gaining precious little inflation relief. "Supply-side" tax cuts in 1981, exceeding expenditure cuts, will spur inflation and undermine the tight monetary policy. Why is the double-and-incompatible overdose the recommended treatment? Why won't it work?

Reagan became committed to his present economic policy package during the campaign. It had an upbeat message, in sharp contrast to Carter's theme that things-are-tough-all-over. Reaganomics offers the closest thing to having a cake and eating it too, by suggesting vast tax cuts able to generate new tax revenues, and hence not necessitate parallel cuts in government expenditures. While public opinion polls show that this was one of the least credible items of the Reagan campaign, after his landslide victory, it became a part of that success story. But as the Carter Administration has just spent four years showing, if demonstration was needed, winning an election campaign is not the same as governing effectively. It is time now to shift from election slogans to realistic economic policy.

The incoming administration's reluctance to adapt their policy is not helped by the fact that within the sizeable group of Reagan advisers there are two camps, one keener on tight monetary policy, one on supply-side tax cuts. With the President both not particularly versed in economics (you see, I don't seek to malign him) and rather inactive, the various Presidential deputies, who have run the transition, have found it wise to compromise. After a "friendly" debate, the course charted so far combines what *both* camps favor, which may be typically "political" but is economically highly inadvisable. Why?

HYPER INTEREST RATES: INFLATIONARY CURE OR CAUSE?

When medicine was as primitive a science as economics is now, doctors used to bleed patients; if they did not improve, the doctors bled them some more. Some patients died; many merely got sicker. When the high interest rates of 1980, and the recession which followed, brought but limited and temporary relief from inflation, those who advocate tight monetary policy as a cure called "instead" of pushing up interest rates—for pushing down the money supply. However, the Federal Reserve Board cannot effectively control the money supply, if only because American borrowers

can freely avail themselves of the huge Eurodollar market. And the effect of constricting the money supply has been hyper interest rates. As the recessionary effect of such rates is typically delayed for about six months, the economy has continued to look strong in recent months and the Federal Reserve Board continues in effect to push up interest rates. As a result, when the induced recession finally hits, it will be deeper but not more effective.

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To see why recessionary monetary policy will not work, one must examine the psychological plug used by the monetarists to seal a gnawing gap in their conception. Economic theory used to say that if prices go up, "all other things being equal," people will buy less (i.e., demand will be lower); thus a new "balance" will be achieved between what is available and the amounts of it people seek. In recent years, people did the *opposite* of what economic theory said they will do. As prices rose, people bought *more*, fearing prices would rise still further. This is known as hedge-buying. For instance, early in 1976, when inflation was relatively low, 44 per cent of a national sample of Americans felt it was a "good time to buy"; as inflation escalated, in 1978, the proportion rose to 66 per cent. Demand thus *grew* as prices *rose*, and people ran down their savings to unprecedented low levels and took out ever more loans, all the time pushing up demand—and prices. The current inflation, you see, is not all the doing of the big-bad government, though the government may well have triggered it by deficit financing of the war in Vietnam; people's changed expectations are inflationary, too. "Changed expectations" is the psychological plug for the gap in economic theory, the explanation why people have failed to respond to higher prices as the theory would predict and thus helped push inflation out of control.

While economists correctly noted that the new expectations contribute to inflation, their notions as to what might reverse these expectations are ill-founded. After all, "expectations" are psychic states, and their dynamics, what makes them rise or fall, is a matter on which economic theory has little to say, to put it gently. Experience, though, is clear: The 1980 recession had precious little effect on inflationary expectations. With the new type of inflation we have—largely propelled by non-market forces such as foreign governments jacking up oil prices, the Federal Reserve Board in effect setting high mortgage rates, doctors largely determining health costs, which are not paid

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directly by their patients and hence not subject to a free market—weakening the economy does not reduce prices by much. (Some calculations suggest that for every 8 per cent of decline in GNP, the U.S.A. gains price relief of only 1 per cent.) To put it differently, ours is not a typical "excess demand" inflation but one largely propelled by managed and semi-managed prices, and by expectations.

There is no reason to believe that a *second bout of recessionary treatment* will reduce inflationary expectations any more significantly than the first one. People are not that stupid; they realize that sooner or later a government-induced recession will be over, that whatever price reductions they see are temporary, because the factors underlying inflation are unchanged. Hence, the public either continues its hedge-buying, or resumes such buying as soon as the recession wanes. Ah, say the monetarists, we need a *longer* recession to get at inflationary expectations. Ah, say the savvy heads (e.g., Irving Kristol in a recent editorial), no people will put up with such a recession for long; it is not "political." Ah, say the monetarists, if you cannot bleed the patient for long, bleed him a lot at once. Thus, urges Dr. Friedrich Hayek, the dean of conservative economists, the U.S. needs a recessionary *shock*. Say I—neither will work, because people realize that all recessions—longer, deeper—are temporary. After the recession, both the deeper causes and people's expectations are more or less where they used to be, only more so, because with each recession people *learn more*—not to heed recessions. No wonder the U.S.A. crawled out of the last two recessions with a higher rate of inflation than before.

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Hyper interest rates are not only a "downer," causing unemployment and idling of productive capacity, but, at least in the short run, a major inflationary *cause*. The CPI rose 12.6 per cent from November 1979 to November 1980; 18 per cent of this rise was due to the increase in mortgage rates. As Alfred E. Kahn pointed out recently, after he had left the White House, the October 1980 increase in CPI, annualized, would have been 8.7 per cent if mortgage rates were excluded, vs. the 12.7 per cent recorded. According to the Bureau of Labor Statistics, in the current economy every 1 per cent rise in the CPI increases government costs for indexed programs by more than \$1 billion. Thus if interest rates were held at a level of, say, 12 per cent and the CPI were thus lower by at least 3 per cent, the government could save \$4 billion on indexed programs. Moreover, since, as recent OMB estimates indicate, a 1 per cent increase in interest rates at the beginning of 1981 would increase federal debt service costs in fiscal 1982 by \$4.2 billion, a drop of several percentage points in interest rates would save the government another \$10 billion or more. Indeed, the side effects of higher interest rates are

a major reason recession combines with inflation.

Wait a moment: The CPI does not cause inflation, it measures it, one may well protest. The problem is not to bring down the CPI, but inflation, right? Well, no. The measure is part of the problem. The CPI vastly exaggerates the true inflation rate; it's like a faulty thermometer which makes us dump a patient in an ice bath as it reads 106 when actually the temperature is but 103. Those who focus on expectations and seek psychological fixes might study the effects of the inflated CPI, and the results of correcting it, rather than prescribing deeper, longer recessions. The quickest way to lower the CPI significantly and undercut inflationary expectations may well be lower, steady interest rates.

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For those who say that interest rates are not really high, because after you deduct inflation the borrower in effect gets little return, one must say, first, that even by this test, interest rates of 18 per cent and higher are too high when inflation is at 12 per cent; and, second, that hyper nominal interest rates drive people to buy tax-free municipal bonds instead of investing in stocks and corporate bonds, the source of capital for the private sector, and thus to pump up the public sector while weakening productive capacity. This is but one reason a highly restrictive monetary policy is not only not effective by itself, but not compatible with the other element of Reaganomics, supply-side tax cuts.

SUPPLY-SIDE TAX CUT: WRONG BENEFICIARIES. WRONG YEAR.

If the Fed continues to restrain the money supply, as its contribution to curing inflation, its task will clearly be made much more difficult by a 1981 tax cut which exceeds reductions in government expenditures, as chairman Paul Volcker made quite plain. The expenditure cuts Stockman advocates in his now famous Kemp/Stockman memorandum are pegged at \$13 billion for 1981. The recommended 1981 tax cut amounts to some \$40 billion. This would clearly balloon the budget deficit *even* if some new revenue were generated by the tax cut, and very few seriously believe in the Laffer notion that all the revenues lost will be recaptured in this way in the short run. (This might have worked in different circumstances, when the economy was down due to lack of demand, but hardly in the present condition.) Hence, a tax cut which precedes and significantly exceeds expenditure cuts in 1981 is clearly mistimed. Indeed, when I raised this issue in a December 10 economic conference on the Hill, one of the key Reagan advisers responded by saying, "Well, the President proposes, Congress *disposes*." I understand this to mean that Reagan might not mind keeping his campaign promise by proposing a Kemp/Roth tax cut, but might not fight terribly hard if Congress stretched

it out (e.g., did the 10-10-10 over five years) or deferred it (e.g., started the clock in June 1981 or, better, January 1982). This might be a major step in the transition from campaigning to governing.

Last but not least, the Kemp/Roth tax cut is aimed chiefly at individuals, not at investment, productivity, R&D—the engines of economic growth and reindustrialization. This is so despite the fact that, as Lou Harris puts it, "For the first time in modern political history, Americans are more willing to give business a better tax break than to give themselves one—provided that the private corporate sector uses these tax incentives to make the economy grow."

WHAT IS TO BE DONE?

First and foremost, the goals of economic policy must be vastly moderated. Reagan has promised the electorate to balance the budget, reduce inflation, secure economic growth and jobs, increase defense spending, and reduce energy dependency. Well, this will not be achieved in the next two years any more than Reagan can walk on the Potomac. The tough question is: Which goals are to take precedence for the near term? Without clear priorities, *no* economic policy makes sense or can work.

First priority must be accorded to fighting inflation, about to take off into still higher rates, as the labor unions, after years of relative moderation, try to catch up and as a result raise the hardcore, underlying inflation rate, and the public's expectations, heightened by the election, are due for another jolt. If inflation rises into the high teens again it might well break into the mid-twenties, and quickly lead to the Latinization of North America, undermining all economic tools and goals. Saving and the long-term bond market are already severely challenged. Next to go will be other sources

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of raising capital, essential for a healthy economy, shorter maturity bonds and stocks; then, the dollar. It's hence very dangerous to spur growth first (via tax cuts) and worry about inflation later.

Spurring economic growth should be given second priority, because in the *longer run* it is the only solution: to provide more of what the nation needs and the public seeks. The same tax cuts which are so inflationary now will be clearly called for once the CPI is reduced and kept lower for a while, if only by lower and steadier interest rates.

While narrowing the federal deficit is an integral part of a drive to reduce inflation, aiming to balance the budget in 1981 or 1982 would undermine the credibility of the policy makers. With recession driving government costs up and revenues down, it is not in the cards. Similarly, all other goals, from energy-independence to enhancing equity, with the possible exception of defense, may well have to be deferred.

If these are the priorities, what is to be done? Monetary policy should not make a fetish of a particular volume of money supply, and surely it should not treat money supply as separated from interest rates. If those have reached a point that they are recessionary and inflationary, they should be allowed to fall and hold steady at a lower level, say 12 per cent.

As to tax cuts, they should be initiated after expenditures have been reduced, beginning with 1982. As economist Martin Feldstein of Harvard pointed out, a tax cut brings the greatest benefits when it is in our future: it allows people to prepare for it; the least beneficial tax cut is one granted after the fact: it has no spurring effects. Hence, to introduce Kemp/Roth in 1981 for 1981 is as wasteful as it is inflationary.

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Most important, tax cuts should to a significant extent be aimed directly to spur growth. This is best achieved via the Capital Recovery Act (which allows for more rapid tax write-offs for those who buy new equipment and plants), because it delivers the stimulant chiefly where there is obsolescence and it benefits successful corporations. (It provides little for laggards which have no profits and hence no taxes from which to write off.) Above all, it wastes nothing on residential housing and collectibles. Second best is a reduced capital gains tax; third, new incentives for saving. In the longer run tax credits for R&D are very productive.

All said and done, economic policy must recognize that unless goals are moderated, nothing will work. If curbing inflation and spurring growth are granted first priority, fiscal and monetary policies can be made to work together, instead of against each other, by making monetary policy less recessionary (by setting interest rates less high) and fiscal policy less inflationary (by deferring and refocusing tax cuts). It might seem that the differences between the suggested "moderate" approach and that flagged by the Reagan campaign are minor. But they may amount to the difference between a dose and an overdose. Thus, a 6 to 8 per cent difference in interest rates may well make the difference between a recession and moderate economic growth. A stretched-out and growth-focused tax cut, versus an immediate and individual-focused one, may well make the difference between stimulating inflation and stimulating growth.

Once the moderated goals are successfully advanced in the short run, they will open the door to more ambitious pursuits in the post-1982 era. The support of the public essential for the longer run policies will not be gained by attempting to work on their expectations by recessionary shocks or shooting for economic miracles (such as increasing revenues by *cutting taxes*), but by actually reducing inflation and spurring economic growth.

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