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SENIOR ECONOMISTS DISSECT REAGAN ECONOMIC PLAN

Never have so many gambled so much on the basis of so little economic evidence. With this in mind, the Federation has assembled five distinguished economic contributors to assess the Reagan plan and has included in this issue the comments and apprehensions of some others.

In the first piece, Robert Solow comments that it is hard to take the well-publicized promises of supply-side economists seriously and observes that they "may not even be meant seriously." For some of the Reagan plan no relevant research findings could even be quoted, and where there is some relevant research the predicted effects, while in the right direction are "nowhere near" large enough to validate the Administration's promises.

James Tobin dissects the Administration's reliance on monetary policy and finds its theorists "under the illusion they can split the economy in two: let the Fed take care of money and prices, while budget cuts, tax relief, and deregulation get the real economy moving again."

But how will the Fed take care of money and prices? The Thatcher-Volcker approach relies on the threat and actuality of economic distress to bring disinflation via a painful transition with high unemployment, stagnation and even recession. The Reagan Administration has rejected this approach believing that their optimistic inflation forecast will be self-fulfilling with workers slowing down their demands for wages in anticipation of the forecast's accuracy! Tobin predicts continued stagflation. His technical analysis is supported by Congressional Budget Office calculations.

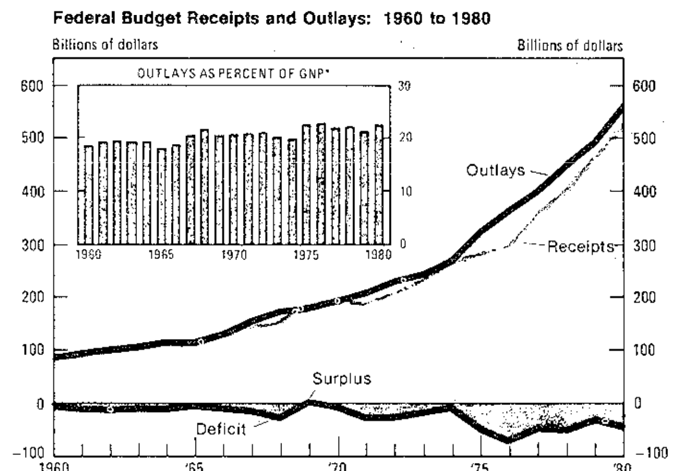
Joseph Pechman addresses tax policy—the centerpiece of the Reagan plan—in which individual income tax rates would be lowered by 30% over three years (the Kemp-Roth proposal), and depreciation allowances would permit rapid write-offs for structures, equipment and vehicles (ten years, five years and three years, respectively). But these tax cuts do little more than offset the increases caused by inflation and accordingly, are hardly likely to inspire those dramatic effects on the economy claimed by Kemp-Roth adherents. Meanwhile, even the accelerated depreciation method keeps business taxation hostage to inflation. Thus the overall effects of the Reagan tax plan are judged by Pechman to be modest.

Henry Aaron observes that the full amount of as-yet-unspecified cuts would require that non-defense programs (other than those in the social safety net) would have to be reduced 40% between 1981 and 84 after adjustment for inflation. Meanwhile "tax expenditures" i.e., tax loopholes, are being ignored.

After reviewing the historically multifaceted quality of regulation policies and issues, Kenneth Arrow warns that there is no reason to doubt that the Administration will subordinate concern for safety and protection from environmental hazard to budget policy, and sees specific dangers to the preservation of land and the quality of the air.

And what of the defense sector, about which FAS will be saying more in due course. During the Vietnamese war buildup the gross national product was about $800 billion or 20% of the $4 trillion it will be soon. But the failure to raise $20 billion in taxes to finance that buildup represents 20% of the kind of $100 billion deficit the Administration is about to run. Will the Fed be willing and able to hold interest rates high enough to finance this national overrun without stimulating further inflation? The prime rate is already at 19.5%.

And even if, in macroeconomic terms, a precarious balance is maintained, what about the sectoral pressures for inflation coming out of the defense sector? According to the Congressional Budget Office inflation in the defense purchasing sector has recently leaped 5 percentage points higher than inflation elsewhere where formerly it was only about 1.5 points higher. (See pg. 2) And even if defense procurement inflation stays only a few percent higher than the Administration expects, Defense appropriations between the present and 1986 would total $130 billion(!) more than anticipated. JJS



SOLOW—3; TOBIN—5; PECHMAN—8; AARON—9; ARROW—11

SOME CREDENTIALS OF THE CONTRIBUTORS

Robert Solow, through whose good offices these contributions were secured, is among other things the Treasurer of the Federation. A former President of the American Economic Association and winner of its John Bates Clark medal (1961), he has held the highest academic rank at MIT since 1973, as Institute Professor.

James Tobin, an FAS Sponsor, was a member of the Council on Economic Advisors from 1961-62. A former President of the American Economic Association (1971), he was awarded its John Bates Clark medal in 1955. He has been the Sterling Professor of Economics at Yale since 1957.

Joseph A. Pechman has been director of economic studies at the Brookings Institution since 1962. A former Vice President of the American Economic Association (1978) and a former President of the American Finance Association (1971), he is the author of a number of works on tax policy and has been the editor of the well-known Brookings annual survey "Setting National Priorities."

Henry Aaron is a senior fellow at the Brookings Institution and Professor of Economics at the University of Maryland. A former Undersecretary of HEW (for Planning and Evaluation), he was Chairman of its Advisory Council on Social Security from 1978-79. A former staff economist to the Council on Economic Advisors, he is currently on the executive committee of the American Economic Association.

Kenneth J. Arrow, an FAS Sponsor, won the Nobel Prize in economics in 1972 and is professor of economics at Stanford University. He has been president of the American Economic Association (1973), of the Econometric Society (1956), of the Institute of Management Sciences (1963), and was the recipient of the John Bates Clark medal of the AEC in 1957. □

GNP AND DEFENSE PURCHASE DEFLATORS

(Percent change, fiscal year over fiscal year)

	76	77	78	79	80
Deflator	**7.0**	**6.8**	**6.8**	**8.7**	**9.3**
Defense Purchases	**7.9**	**7.3**	**7.7**	**9.0**	**14.9**

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SUPPLY-SIDE ECONOMICS

Robert M. Solow

The labels "supply-side" and "demand-side" tell you as little about the real issues in the current debates over economic policy as the colors of the roses tell you what really divided the Yorks and the Lancasters in the 15th century. Serious supply-side economics is not a recent discovery. Supply and demand as "two blades of the scissors" is one of the enduring cliches of economics.

More to the point, as recently or as long ago as 1962, such dyed-in-the-wool Keynesians as the Council of Economic Advisers in the Kennedy administration gave explicit prominence to supply considerations both in their analysis of the macroeconomic prospects and in their policy recommendations. The investment tax credit was launched in 1962, and it was followed in the next couple of years by favorable Treasury revision of depreciation guidelines for tax purposes, and by a reduction of corporate tax rates. No one doubts that the result was a stimulus to business fixed investment, though there is continuing discussion within the economics profession about the precise size of the increment to cumulative investment spending thus accomplished. It is one of the paradoxes of our time that candidate Carter's tax proposals during the 1980 campaign were more heavily weighted toward the provision of investment incentives for business than were candidate Reagan's.

To be viable, a path for aggregate output of consumer goods and capital goods and an accompanying path for the price level must satisfy two kinds of conditions. There must be a market for those goods at that price level—the demand side—and the capacity, cost and profit relations must be such as to induce the required production decisions—the supply side. One or the other might be more problematical at a given moment, but both matter in principle.

At Issue: The Magnitude of Effects

What, then, is all the shooting about? If there is any substance to it at all, it is a dispute about the quantitative magnitude of effects, and not a subtle dispute either. The Reagan administration's fiscal policy appears to be generally expansionary, even mildly inflationary, if one includes the second and third installments of the Kemp-Roth personal income tax reduction and the proposed increase in military spending over the next four or five years. The administration asserts that their demand expansion will be fully offset by a vast expansion of the economy's ability and willingness to produce without an inflationary run-up in prices. The question is whether there is anything to this claim.

The supply expansion is supposed to come from three sources. Business-tax reduction is expected to make plant and equipment investment more profitable. (The Administration favors the 10-5-3 proposal for accelerated depreciation, though nearly all professional opinion thinks it inferior to other devices for accomplishing the same purpose.) In consequence, by 1984-1986 business will have more and newer productive capacity. Lower marginal personal tax rates, leaving to the individual a larger fraction of in-

Robert M. Solow

cremental earnings, will encourage market-oriented work. So the supply of labor will be larger than otherwise. Finally, the elimination of onerous regulation is expected to release a burst of ingenuity and innovation that will again generate greater productive capacity and lower costs in American industry. What are we to think of these claims?

Take the last one first. It is simply a shot in the dark. No relevant research findings are—or could be—quoted. No one can say with complete confidence that the story is impossible. But neither is there a shred of evidence that deregulation will have more than small effects. The deregulation of the airlines in the Carter administration is

(Continued on page 4)

ECONOMIC LOGIC, POLITICAL REALITY AND SOCIAL JUSTICE

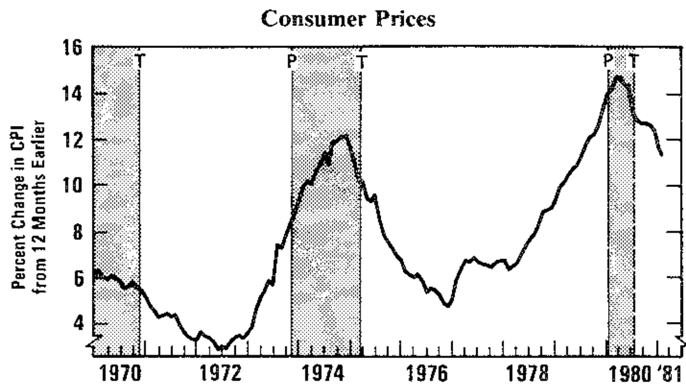
"Super supply-siders seem to be quite unfazed by the devastating evidence to the contrary. They even choose to ignore common sense and arithmetic showing that the jump in demand would be much bigger and faster than any conceivable jump in supply. It is widely accepted that tax cuts have a multiplier of about two on the demand side. That is, a $30 billion tax cut rather quickly turns into about $60 billion of additional demand for goods and services. But the effect on supply comes to only a few tenths of a percent, and that rather slowly...

If the current tax-cutters want to draw the right lesson from the Kennedy tax-cut experience, it would be this: Utilize the existing margin for tax cuts first and foremost for carefully crafted and sharply focused incentives to capital formation and cost-cutting. Then, after these are firmly in place and budget-cutting has moved from rhetoric to reality, use the further elbow room for broad-gauged personal tax cuts...

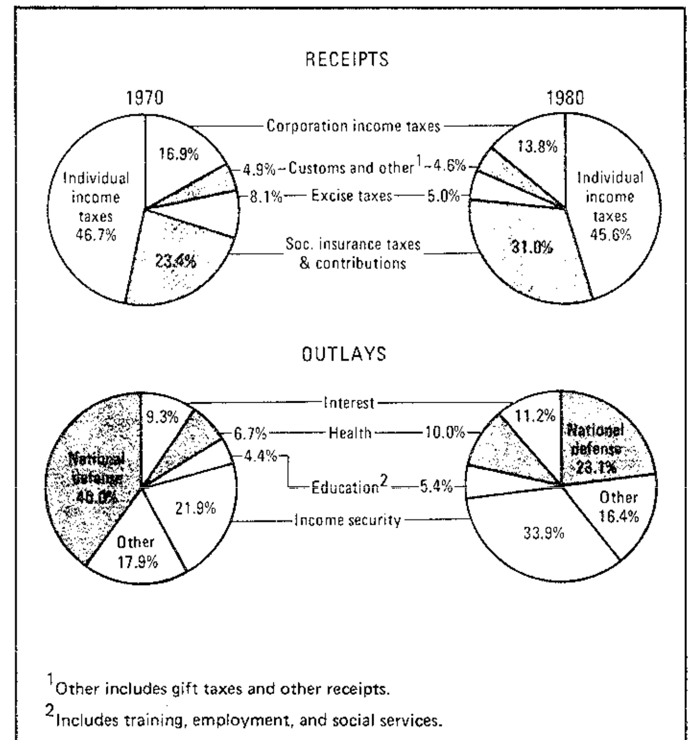
Soon, the nation will have to face this hard question: Can we afford the risks and costs of a full Kemp-Roth tax plan, or will the tax cuts have to be scaled back to stay within the bounds of economic logic, political reality and social justice? The answer is implicit in the question."

Walter W. Heller, Wall Street Journal, February 10

Consumer Prices



Federal Budget - Percent Distribution by Function: 1970 and 1980



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generally adjudged to have been a success, with some accompanying gains in efficiency. But the laws of aerodynamics are in no danger.

On each of the other claims there is a body of relevant research. The effects are in the right direction, but nowhere near large enough to validate the Administration's promises. I have already mentioned that there is uncertainty about the quantitative effectiveness of investment incentives. But even estimates at the optimistic end of the plausible range suggest that the additional stock of capital after some years will be enough to add at most one or two percent to national productive capacity. This is well short of what would be required to lend substance to political claims.

Supply-Effect Weak

On the labor side, the story is the same. There is a history of estimates of the elasticity of supply of labor (the proportional increase in hours of work offered in response to a small proportional increment in the after-tax wage). In principle, there are two offsetting effects: the greater reward for incremental effort makes work more attractive (the "substitution effect"); but larger family earnings may discourage secondary workers from entering the labor market (the "income effect"). The weight of the evidence is that each one-percent increase in the after-tax return to effort generates at most a half of a percent of net labor supply, and probably substantially less. Furthermore, this supply-side effect appears to be stronger for low-wage workers than for those at higher levels of income, whereas Administration proposals offer little or nothing at the low end of the scale but instead splash the already well off.

This suggests one last point. It is well understood that investment incentives have regressive effects on the distribution of income. That is to say, they give bigger benefits to businesses and stockholders than to others; they may work to increase aggregage income, but they distribute it more unequally. No doubt this helps to account for the universal popularity of such programs within the business community; and no doubt it helps to account for some of the Administration's policy choices. Those with more egalitarian tastes can still favor the stimulation of investment as an aid to economic growth; but they can look for particular policy devices that provide more stimulus per dollar of revenue lost.

On the whole it is hard to take the well-publicized promises seriously. They may not even be meant seriously.☐

THE VIETNAMESE INFLATION REVISITED?

"President Johnson's refusal to raise taxes to pay for the Vietnam War is legitimately remembered as one of the key factors leading us into our current economic mess. He wanted both the Great Society and the war. But if he was to have both and not wreck the economy, his only option was to raise taxes sharply. He chose not to do so, and he wrecked the economy.

President Reagan wants both dramatic tax cuts to encourage investment and an even more extensive military buildup. But he cannot have both without wrecking the economy further unless he is willing to raise taxes dramatically on private consumption. He has chosen not to do so. If his current program is carried out, he too will wreck the economy."

Lester Thurow, New York Review of Books, May 14, 1981

" 'The Johnson Administration was justly criticized for increasing defense spending without raising taxes; they're trying to do the same thing,' said Otto Eckstein, President of Data Resources, in discussing the Reagan plans. Doubting that social programs will be cut as extensively as planned, Mr. Eckstein asserted that the military buildup was reminiscent of the Vietnam era, and added: 'Prudent analysts would have to conclude that it's a very risky strategy.' "

Otto Eckstein to Winston Williams, New York Times, March 19, 1981

MONETARY POLICY: THE COLLISION COURSE

James Tobin

President Reagan's Program for Economic Recovery promises gradual, and eventually substantual, relief from inflation. According to the official scenario, the inflation rate will be halved in five years, from 10% this year in the comprehensive price index (the Gross National Product "deflator"), to just under 5% by 1986. Ambitious as this goal seems today, it was 5% inflation in the early 1970s that the Nixon Administration found intolerable when they invoked wage and price controls.

The Reagan Administration assigns principal responsibility for disinflation to the Federal Reserve System. Over the coming five years, the "Fed" is to cut in half the rate at which it allows the stock of money to grow. The "Fed," as Chairman Paul Volcker has repeatedly emphasized, was already committed to gradual reduction of its targets for monetary growth. The Administration, while urging better marksmanship, is simply confirming a long-standing policy.

However, the agreed monetary policy does not support the optimistic projections of output and employment in the Reagan scenario. Volcker recognizes that disinflation may require a painful transition with high unemployment, stagnation and even recession of output, and business losses and bankruptcies. Like Margaret Thatcher, he hopes that public understanding of the government's determination to stick to its restrictive policy will speed the transition and limit its damage. The President and his economic officials see no transitional costs and no need to issue Thatcher-like threats. They are under the illusion they can split the economy in two: Let the Fed take care of money and prices, while budget cuts, tax relief, and deregulation get the real economy moving again.

The likelihood of collision can be exhibited in the framework of Irving Fisher's Equation of Exchange: MV = \$GNP = PQ. Here M is the stock of money in dollars. (M-1B, public holdings of currency plus checkable deposits in banks and thrift institutions, is currently the Fed's preferred measure; it averaged \$413 billion in 1980.) V is its velocity. (In 1980 the average number of times a dollar of M-1B bought final goods and services counted in GNP was 6.4.) P is the price level. (In 1980, the GNP price index was 177 relative to the 1972 base of 100.) Q is the volume of "real" output per year. (In 1972 dollars, GNP was \$1481 billion in 1980.) Both sides of the identity give the current-dollar or "nominal" GNP, \$2626 in 1980.

In terms of proportional rates of growth, the Equation of Exchange implies (approximately for finite periods) the following identity:

$$\frac{\Delta M}{M} + \frac{\Delta V}{V} = \frac{\Delta \$GNP}{\$GNP} = \frac{\Delta P}{P} + \frac{\Delta Q}{Q},$$

for which the figures for 1980 over 1979 were, in percentages, 6.7 + 2.2 = 8.9 = 9.0 - 0.1. Table 1 gives the official Reagan scenario for inflation $\frac{\Delta P}{P}$ and real growth $\frac{\Delta Q}{Q}$, along with Reagan-Volcker targets for decelerating monetary growth $\frac{\Delta M}{M}$. From these we compute required velocity growth $\frac{\Delta V}{V}$.

Now the velocity of M1-B has been steadily climbing, thanks to ingenious innovations that have enabled

(Continued on page 6)

TABLE 1 Monetary Growth Targets v. Reagan Projections of Inflation and Real Growth
The Implications for Monetary Velocity

Year	(1) Monetary Growth $\frac{\Delta M}{M}$ (M-1B)	+ (2) Velocity Growth $\frac{\Delta V}{V}$	= (3) Nominal GNP Growth $\frac{\Delta \$GNP}{\$GNP}$	= (4) Price Inflation $\frac{\Delta P}{P}$	+ (5) Real GNP Growth $\frac{\Delta Q}{Q}$
	(percent per year, yearly averages)				
1980 actual	6.7	2.2	8.9	9.0	-0.1
	Announced Policy	Implied by Other Columns	Reagan Administration Projections*		
1981	3.5 - 6	6.6 - 5.1	11.1	9.9	1.1
1982	3 - 5.5	8.8 - 7.3	12.8	8.3	4.2
1983	2.5 - 5	8.9 - 7.4	12.4	7.0	5.0
1984	2 - 4.5	7.8 - 6.3	10.8	6.0	4.5
1985	1.5 - 4	7.3 - 5.8	9.8	5.4	4.2
1986	1 - 3.5	7.3 - 5.8	9.3	4.9	4.2

*Office of Management and Budget, *Fiscal Year 1982 Budget Revisions,* March 1981, Table 6, p. 13.

Discrepancies between (3) and (4) + (5) are in original source and are due to second order effects $\frac{\Delta P}{P} \cdot \frac{\Delta Q}{Q}$, quarterly compounding, and rounding.

(Continued from page 5)
businesses and other bank depositors to handle their transactions with ever smaller cash balances. But the annual growth rate of M-1B velocity has never averaged more than 5% for any two-year period in the 1970s. Furthermore, money turnover rises fastest when interest rates are very high, as in credit crunches preceding recessions. The Administration projects declining interest rates, consistent with its forecast disinflation; should these rates materialize, incentives to economize cash would diminish and velocity would rise more slowly. For these reasons, it is unlikely that the Reagan recovery can be financed by the planned and announced monetary policy.* That is, $GNP will not grow as fast as projected. Something will have to give, and almost surely it will be $\Delta Q/Q$, real output growth.

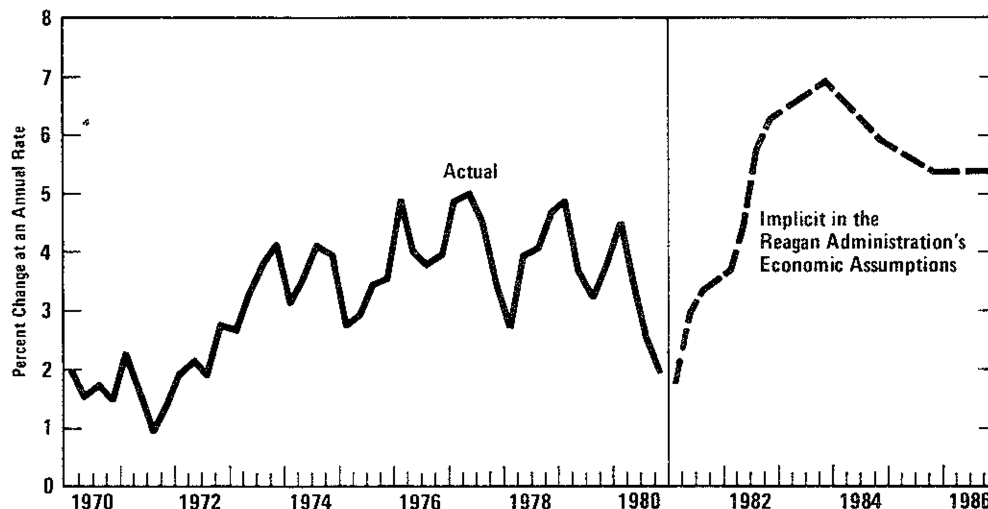
Even if the growth in $GNP in Table 1 were realized, its forecast split between output growth and inflation is exceedingly optimistic. Today's 10% inflation reflects a solidly entrenched pattern of annual 10% increases in dollar wage rates. Even with good luck on the prices of oil, food, and imported materials, no durable progress against inflation is possible unless the stubborn trend of labor costs is broken. Restoring productivity growth to 2-3% per year would help, but only if the improvement did not show up in higher wage settlements. Anyway there is no conceivable supply-side miracle that could reconcile 10% wage inflation with 5% price inflation.

*A technical point about M-1B: Recent regulatory changes, notably the Monetary Control Act of 1980, have generalized the availability of interest-bearing checking accounts and made deposits included in M1-B more attractive. The Fed will accommodate the resulting one-time shifts into M1-B, away from time deposits, certificates of deposit, money market funds, and the like. The figures for $\frac{\Delta M}{M}$ and $\frac{\Delta V}{V}$ in Table 1 are the Fed's targets *after* subtracting the growth in 1981 necessary to accommodate these shifts.

James Tobin

So wage inflation must come down. There are really only two ways to bring it down. One is the Thatcher-Volcker approach, relying on threat and actuality of economic distress until firms fearing insolvency and workers afraid of losing their jobs break the existing pattern of wage and price inflation. The other is to organize concerted disinflation by wage-price controls or other "income policies" (for example, gradually declining guideposts with tax-based carrots or sticks that induce compliance) during the transitional period.

The Reagan Administration rejects both approaches. They say instead that their optimistic inflation forecast will be self-fulfilling—firms and workers will believe them and,



A Congressional Budget Office diagram illustrating Tobin's conclusion. CBO observed: "As can be seen, the assumed growth rates in the velocity of money substantially exceed previous experience. More troublesome, the rapid rise in money velocity is assumed to occur simultaneously with a substantial drop in interest rates. Since velocity growth is a rough measure of the demand for money relative to supply, the assumption is that the price of money—interest rates—will fall while the relative demand for money is strong.

expecting lower inflation, slow down the increases of their own prices and wages. But there is nothing in their frenetic budget cutting and tax-cutting to make the inflation forecasts a credible basis for action by managements, union leaders, and workers. The threat implicit in Fed Chairman Volcker's policies might not have had much impact at best, judging from Britain's experience under Mrs. Thatcher. But the President's rosy scenario destroyed its chances. Few outside the esoteric worlds of finance and economics know who Paul Volcker is, much less what M-1B is and what it means for their sales and jobs.

The most likely outcome is a continuation of stagflation, with little sustained progress against either unemployment or inflation. Yet the Congress and the public have been sold the Reagan budgetary and tax medicines, many of which they find intrinsically distasteful, precisely on the ground that they are necessary and sufficient to conquer stagflation. ☐

INFLATION RATES BY SELECTED CATEGORIES OF THE CPI

	1978	1979	1980
All Items	9.0	13.3	12.4
Energy	8.0	37.4	18.1
Mortgage Interest Costs	22.0	34.7	27.6
Food	11.8	10.2	10.2
Remaining Items	7.3	8.6	9.9

MONETARY POLICY: CONTROLLING THE UNDEFINABLE

"Unfortunately central banks have not yet learned to control the money supply with any precision. Nor under modern circumstances, when money can be anything from currency to bank deposits to savings deposits to unused lines of credit, is it at all clear what is to be controlled. Controlling what you don't know you are controlling is difficult....The reliance on monetary policy has...been deeply damaging to the economic and social consensus. Fiscal action which controls demand by controlling private and public consumption would have been less so. It is more predictable in effect, it does not favor the large firm over the small, and, since its restraining effect is on consumption, it is not directly damaging to productivity. Unfortunately fiscal policy—higher taxes, reduced public expenditure—is, to put it mildly, politically inconvenient. For this reason policy makers in recent times, looking as ever for soft solutions, have been reluctant to use it. Instead we have combined inflation with tax reductions and compensated with ever more severe monetary policy."

John Kenneth Galbraith, New York Review of Books, January 22

DEFENSE SECTOR SHRINKS; ITS INFLATION RATE RISES

"But the CBO also believes that the administration underestimates the rate at which the prices of defense-related goods are rising. To complete the programs in the Reagan budget could cost $50 billion more by 1984 than the administration expects, CBO has estimated.

Defense-sector inflation is another area that has received almost no public attention in the discussion so far over Reagan's defense proposals. In fact, prices for military goods are rising 50 percent faster than the underlying rate of inflation.

Some weapons systems have more than doubled in cost just in the last two years. The unit cost of the Army's new, advanced armored personnel carrier, for example, rose 94.8 percent in 1979 and another 65 percent in 1980. A modified version of the C130 air transport equipped with advanced electronics went up in price 75.9 percent in 1979 and another 26 percent last year. The price of an F18 jet fighter, in which the Reagan Administration plans to invest heavily, went up 25 percent in 1979 and 44 percent in 1980.

Overall, the costs of the 47 major weapons systems now being purchased by the Pentagon rose more than 20 percent in 1980. According to a CBO calculation, while the underlying rate of inflation in the economy as a whole last year was 9.3 percent, costs of defense purchases went up 14.9 percent. For four years up to 1980, the same index shows, defense-sector inflation was less than a point higher than inflation generally; the sudden jump last year hints at a new explosion in defense costs.

...During the 1970s, when defense spending fell to the lowest levels (as a percentage of GNP) of the postwar era, what has been called the military-industrial complex changed radically. Thousands of small firms that were subcontractors to the giant defense firms in the 1960s—providing 50 to 60 percent of the components of most major weapons systems—went out of business, or out of the defense business.

In many critical areas, there are only one or two firms in the United States that can provide key parts. According to the Pentagon's Defense Science Board, only two companies make the titanium wing skins crucial to advanced aircraft; only three firms make aircraft landing gears; just one manufactures special ball bearings for air frames. Only two shipyards in the country—both of them already working at full capacity—can build many of the ships in the new Navy budget.

As a result of real or potential bottlenecks such as these, the waiting times for the Pentagon to take delivery on major weapons systems after they are ordered have stretched into years."

Robert Kaiser, The Washington Post, April 25, 1981

TAX POLICY IN THE REAGAN BUDGET

Joseph A. Pechman

The tax policy proposed by President Reagan is the centerpiece of his program to solve the serious problems of the U.S. economy. It consists of two features: first, the depreciation allowances used by business for tax purposes would be substantially increased; second, individual income tax rates would be reduced by 30 percent across the board over a period of three years (the Kemp-Roth proposal). The new depreciation allowances would be aplied retroactively to all investments made since January 1, 1981, and the rate cuts would become effective July 1, 1981.

The purpose of the depreciation and income tax proposals is to stimulate economic growth and reduce inflation. Tax rates are believed to have reduced saving, investment, and work incentives. By providing a large, permanent reduction in taxes ($53.9 billion in fiscal 1982 and $148 billion in 1984), business would invest more and individuals would save more and work harder. This would break the "cycle of negative expectations...revitalize economic growth, renew optimism and confidence, and rekindle the Nation's entrepreneurial instincts and creativity."

Quantitative Effects of Tax Rates

Economists in general agree that high marginal tax rates distort economic behavior, but they disagree about how much. The more enthusiastic supply-siders believe that the Reagan proposals would pay for themselves by increasing the tax base more than enough to offset the revenue loss from reduced rates. The Reagan administration doesn't go that far—it expects more real growth and less inflation than other forecasters do, but not nearly so much as the extreme supply-siders had been predicting.

The depreciation proposals are more likely than the income tax cuts to spur supply. According to recent econometric analysis, faster depreciation deductions or higher investment credits would increase investment by raising the return on capital, but the Reagan proposal is not the best way to achieve the higher return. President Reagan is asking Congress to enact a modified version of the so-called 10-5-3 proposal he suggested during the campaign. This proposal would permit tax write-offs over a period of ten years for some structures, five years for equipment, and three years for vehicles. Nonresidential structures other than industrial buildings, retail stores, and warehouses used by their owners are to be written off over 15 or 18 years. The modified proposal still favors certain types of investment over others, and does not respond to the fundamental problem of freeing the value of depreciation deductions from changes in inflation. This objective could be accomplished by a scheme, devised by Professor Alan J. Auerback and Dale W. Jorgenson of Harvard University, which would permit businesses to deduct the present value of future economic depreciation in the same year the investment is made. Some interest has been expressed by the tax-writing committees in this approach, but the final bill will probably be a further modification of 10-5-3, leaving business taxation still hostage to inflation.

Joseph A. Pechman

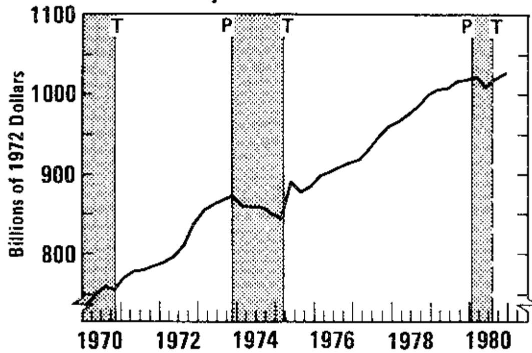
Whatever comes out of Congress, the more liberal depreciation allowances would raise the rates of return in many industries and stimulate investment. But the effect on productivity and growth is likely to be small and slow in coming. Even if all of the business tax cut were invested, productivity growth would rise by only 0.1 to 0.3 percentage points a year.

The proposed individual income tax cuts are the more controversial part of the Reagan package. The tax cuts are smaller than they seem—three-quarters of the cuts are necessary just to prevent inflation and economic growth from increasing real tax burdens through bracket creep. In fact, in the lower tax brackets, the rate cuts would not offset the tax increases caused by inflation, because no adjustment is proposed for the reduction in the real value of the personal exemptions and the standard deduction since they were last adjusted on January 1, 1979. Only for income above $30,000 would there be significant net cuts from the 1980 marginal rates. It is doubtful that the increase in work and saving of those above this level would be sufficient to have the dramatic effects on the economy claimed by the adherents of Kemp-Roth.

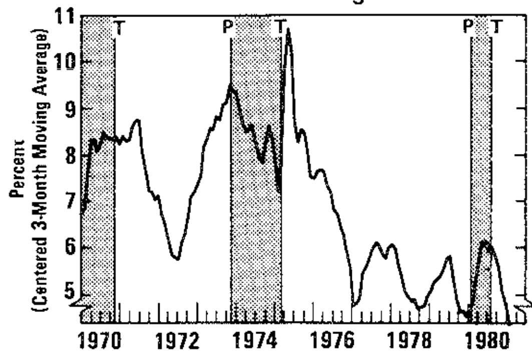
Under the circumstances, the economic effects of the Reagan tax plan, even if it were adopted without change, would be modest. Furthermore, Congress seems to have ideas of its own. Consideration is being given to reducing the marriage penalty on two-earner couples. There is considerable interest in an element of the Kemp-Roth proposal the president did not embrace, lowering the top marginal tax rates on unearned income to 50 percent (the maximum rate now applied to earned income). Such a move would be justified if the annual revenue loss of $3.5 billion were recouped by closing some of the tax loopholes that distort economic incentives (for example, elimination of the tax exemption for interest paid by state and local governments on industrial development bonds). Congress is also interested in encouraging incentives for savings directly

Household Sector Conditions

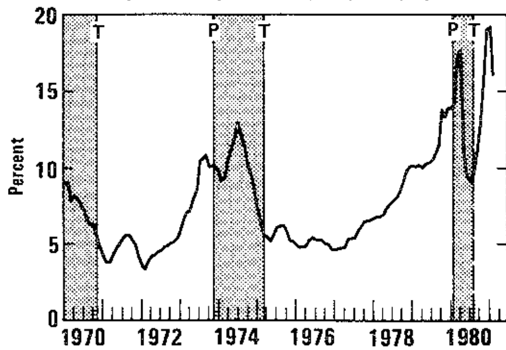
Disposable Personal Income, Adjusted for Inflation



Personal Saving Rate



Short-Term Interest Rate



Source: CBO

through higher exclusions for interest and dividends and more generous limits for saving set aside for retirement. Most of these proposals are costly and have little effect on total saving. Finally, there is considerable support for a further cut in the capital gains tax rates, which are already 60 percent lower than rates on ordinary income.

With all the competing claims, Congress is not likely to act quickly on the tax bill. This would not be a great tragedy. We won't know for some time yet how much outlays will be cut and, with an expected deficit of $60 billion or more before congressional action on the 1982 budget, it would be premature to judge how much elbow room there will be for tax cuts. It is probably wise to take a few more months to hammer out a compromise bill. Whatever its final form, the tax cut will hardly revitalize the economy, but it will provide some relief from the tax increases brought on by inflation. □

BUDGET CUTS

Henry Aaron

Along with large increases in defense expenditures, President Reagan seeks even larger cuts in nondefense expenditures. He proposes to reduce this portion of the budget $48.6 billion below the budget of the outgoing Carter administration. Some programs are cut more than others.

Expenditures under programs christened the "social safety net," which would have reached $269 billion in 1981 under the last Carter budget, will be held to $263 billion, the same as in 1981 after adjustment for inflation. This group includes retirement, survivors, and disability insurance under social security, veterans' benefits, basic unemployment insurance, medicare, and cash welfare payments. Nearly 93 percent of safety net expenditures are allocated on the basis of age, unemployment, national service, or some other criterion not directly related to current income. The 7 percent of expenditures that are income tested does not include most assistance of the poor, which is to be cut substantially.

Proposed cuts in nondefense programs not designed as part of the social safety net are much deeper. Grants-in-aid to state and local government are cut 20 percent in real terms; welfare programs are slashed roughly by the same amount.

Further Cuts Promised

Whatever the outcome of the Congressional battle over the 1982 budget, the President has promised further, as-yet-unspecified cuts, totalling $30 billion in 1983 and $44 billion in 1984. If Congress enacts President Reagan's budget in full, programs other than those of the Department of Defense, those in the social safety net, and net interest will be reduced 40 percent after adjustment for inflation between 1981 and 1984.

Whether or not the combination of spending the tax cuts will do as much to reduce inflation and increase growth as the Administration hopes, many people support at least some reduction in the size and intrusiveness of government. Each of the proposed cut-backs in spending, credit activities, and regulations should be scrutinized to deter-

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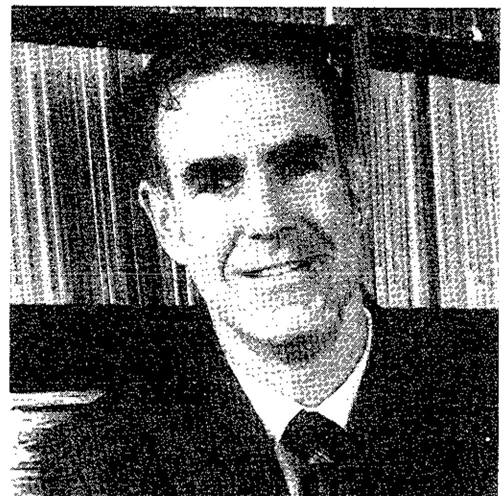

Diana Walker

Henry Aaron

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mine whether the problem that originally led to the program or regulation has been solved and, if not, whether the existing program is as good as alternative methods for solving it. By this test, many of the budget cuts proposed by the Administration emerge with high marks; others do not. The following examples illustrate the numerous choices Congress will face.

The proposed reductions in subsidies to rail passenger travel would reduce or end a mode of transportation that uses more energy then do competing modes and serves a small minority of travelers. Their passage would represent a triumph of hard headedness over nostalgia.

Congress ignored President Carter when he sought termination of the "minimum" social security benefit, which goes in large part to relatively comfortable retired civil servants also eligible for nonintegrated government pensions; it similarly disregarded Carter's request to phase out social security student benefits which overlap other federal student aid. It may well heed the similar cuts proposed by President Reagan.

Termination of interest subsidies on loans to college students does away with a subsidy that was poorly targeted on needy students whose educational plans would be affected by student aid. These cuts and many others are overdue and would free resources for higher priority uses in the private or public sector.

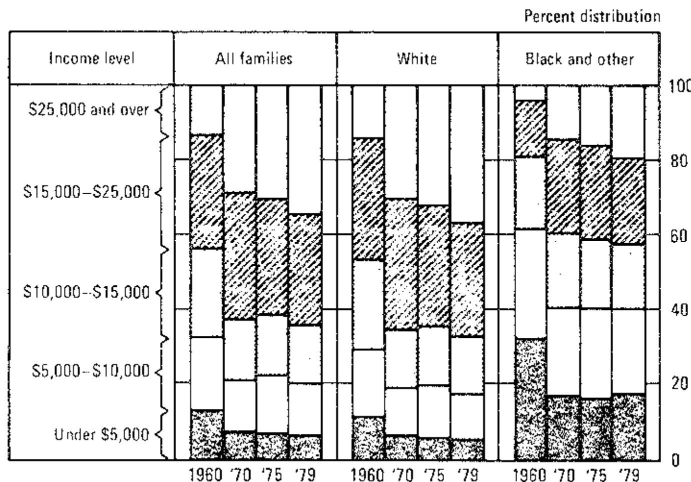
Medical Care Treatment Questionable

Other cuts requested by the Administration are harder to defend. The proposed 5 percent cap on the growth of medicaid expenditures will do nothing to curb the underlying growth of medical costs; it will increase state costs proportionally more for those states where federal aid is a larger than average proportion of total outlays; these relatively low-income states tend now to offer relatively meager benefits. The cap will not distinguish between states that have tried hard to cut costs and those that have not. It will strike at the most important benefit for many poor families, while leaving untouched the much more rapidly growing medicare program that serves mostly middle-class elderly and disabled recipients. Limited cost sharing under medicare would save more money than the medicaid cap and do so more equitably; it would also reduce relatively low priority demands for hospital care.

The budget calls for an end to subsidies to airports and airport users, but it proposes to do so by increasing taxes on commercial passengers whose taxes already cover their share of airport costs, rather than by raising user charges on general aviation which will continue to be heavily subsidized. The gain from subsidizing owners of private planes through a tax on commercial fliers instead of general taxation is hard to perceive.

The budget is silent on "tax expenditures," those revenue losing provisions introduced to achieve social or economic objectives. Most are demonstrably inefficient in achieving those goals. Their replacement with well designed direct incentives would reduce the deficit or make additional room for cuts in tax rates.

Money Income of Families in Constant (1979) Dollars — Percent Distribution by Income Level and By Race: 1960 to 1979



Cuts in research are hard to oppose if other programs are being cut deeply. But there is no basis, other than personal pique among high OMB officials, for the directive that NSF slash social and behavioral science while leaving intact large increases for other sciences proposed by President Carter. NSF, acting in concert with the scientific community, should allocate any overall cuts that Congress enacts.

Specific mention of half a dozen budget initiatives cannot do justice to proposals encompassing virtually every nondefense program, but it can illustrate the complexity of the issues, each requiring careful scrutiny and deliberation.

The comprehensiveness of the Reagan budget plan and the speed with which the new Administration prepared it are impressive. The Administration clearly has concluded that its best chance for success in scaling down spending lies in a political blitzkrieg while the popularity of a new President is high and before he has confronted the risk of economic, political, and diplomatic reverses. While the political judgment may be correct, one hopes that the haste to seize a rare moment of apparent national consensus will not permanently damage social programs vital to the welfare of needy people.☐

Kenneth J. Arrow

REGULATION

Kenneth J. Arrow

The regulation of economic activity in the United States has, broadly speaking, taken two directions: regulation of *prices* and regulation of *quality*. The motives and purposes of the two classes of regulation are different, and even within each class, individual regulations have different motives. The impulse to undertake these regulations has had little to do with economic analysis, though to some extent they can be justified or explained in economiuc terms.

The regulation of certain prices received its start in the latter half of the nineteenth century with the Granger movement in the farm states and then later on the national level. It was a reaction to concentrations of economic power, most especially the railroads but also later grain elevators and the new public utilities, electric power and telephones. The perceived threat was that, in the absence of effective competition, these firms could charge excessively high prices and also could discriminate among different classes of customers. There emerged regulatory commissions, the Interstate Commerce Commission at the national level and state public utilities commissions, with the power to outlaw some forms of rate-setting and to set maximum prices. The legal power of these commissions were clarified only after many years of court adjudications. The basic principle tended to be that regulated firms were entitled to a return of their running costs plus a rate of return on the capital invested which was normal for the economy.

Economists Sought Efficient Allocation

Economic analysis of price regulation developed in response to practice. From the economists' point of view, the relevant question was to determine the conditions under which the free play of market forces fails to lead to an efficient allocation of resources. It was soon seen that the key issue was the presence of economies of scale. Railroads and other utilities required large fixed costs to operate at all, and, in general, incremental costs tend to decline as the scale grows. As a result, competition is usually not viable, since one firm can outstrip all others by expanding and underselling; and if it is viable, it is inefficient, since the economies of scale are not realized. If competition is not viable, then prices will be higher than they would be under a competitive regime. As a result, the amount demanded will be less than the efficient amount; there is a misallocation of resources compared with a theoretical optimum, with less being allocated to the industry in question and more to other industries than is optimum.

Note that this efficiency argument is rather different from the view that motivates the political drive for regulation. The latter is rather concerned with "unjust enrichment"; to the economist, this means a distribution of income which is more inegalitarian. However, it is doubtful that unregulated monopoly contributes more than a small fraction of the observed inequality of income, which has many causes.

When an industry is regulated, entry to it is usually controlled, in order to preserve scale economies and to make regulation easier. As a result, it becomes in the interest of the regulated to preserve the regulation and make competition more difficult. It has even been argued that price regulation has been instituted on occasion under pressure from the regulated industry. Certainly, railroad regulation has been extended to trucking, first in order to protect the railroads against the competition of the new rival and then, in part, to reduce competition within the trucking industry, even though trucking has virtually no economies of scale. Regulation may thus be used to set up cartels with government support, and a strong case for deregulation in particular industries can be made.

Maximum price controls have been established in some industries for different purposes. Rent control cannot be regarded as a response to lack of competition, for housing is everywhere highly competitive. It is rather related to the fixity of capital in housing, so that owners are not in a good position to withdraw their supply in response to rent control. Rent controls have certainly led to very considerable inefficiency in the allocation of the housing that exists and have inhibited an increase in its supply.

Banks Protected by Interest Ceilings

Another form of price ceiling is that on interest rates paid by banks to depositors, who certainly have no monopoly power. The purpose is part of the broader set of financial regulations, which are intended to insure the quality of bank services, in particular the security of the banks to the depositors. It is argued, though without very good evidence, that if interest rates paid were not limited, the banks in competing for depositors would find it necessary to go into more risky and high-paying loans to cover the increased interest costs.

Minimum price regulations are also widespread, most notably for wages and for farm products. Their logic is dubious. Minimum wages which affect relatively few workers at the bottom might be defended as covering situations in which there are insufficient competitive forces in the form of alternative opportunities. However, these minima may not take adequate account of varying circumstances. In particular, there is a strong argument for setting lower minimum wages for young and inexperienced workers, to induce employers to hire them and so develop the skills needed in the adult market.

The second main branch of regulation is that relating to quality. The "blue sky" laws in all states require adequate information on the sale of new securities; subsequently, the Securities Exchange Commission was created to insure a continuous stream of adequate financial reporting. One main justification for this class of regulation is the difficulty of acquiring relevant information. Hence, buyers are considered to be at a disadvantage in all classes of transactions where the product, whether a financial instrument or a physical entity, is complicated in concept and difficult to understand in operation. Sometimes, as in the case of financial markets, the remedy is full disclosure. But in many cases, it is felt that either the information is too complex to be appreciated by the average consumer or he/she will not have enough alternatives to make use of it. Safety

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inspection of steamboats goes back to the middle of the last century; an unsafe steamboat was not permitted to be used, though a conceivable alternative policy would have been simply to post a warning. Perhaps the most important example today is the regulation of pharmaceuticals and food additives for safety and efficacy. There are conspicuous examples of risks avoided by adequate testing procedures. There are also objections that the severity of the testing inhibits innovation.

Since typically food additives and drugs have benefits in the form of consumer satisfaction and health benefits as well as risks, regulatory decision is not always easy. The tendency in practice, partly under the influence of economic thinking, has been toward a systematic comparison of the benefits and costs (including risks) as a basis for regulatory decisions. Some have argued against this position, in favor of a more clear-cut rejection of risks. The matter is complicated by the fact that determination of the risks is frequently very difficult; an increasingly typical situation is that of a suspected carcinogen with a low probability of occurrence. The probability is usually difficult to determine with any kind of precision partly because of its low incidence, partly because we do not want to use human beings as the test cases to determine the risks, and partly because the lag between exposure and effect is so long.

Finally, we come to another form of quality regulation, that of the environment. Here, in fact, economic analysis preceded rather than followed popular attention. Individuals and firms can perform a great many actions which impose costs on others (in some cases, benefits) without having to pay for them. It can be expected then that there will be an excessive amount of such activities. Atmospheric and water pollution are the most conspicuous examples. The burning of coal was already banned in London in the 13th century, because of the nuisance to others. Costs imposed on others have come to be known as externalities. The nature of the externalities includes not only unpleasant characteristics and smells but also health hazards, which are real but often difficult to quantify.

The need therefore for public action has finally been recognized. However, the form and detailed regulation of pollution sources, can be disputed. Most economists have long argued for taxation of pollution to internalize the negative externalities; the polluter is made to pay for the costs imposed on others but can meet the problem in the most economic way. In the last few years, the Environmental Protection Agency has moved increasingly to market-like devices for allocating the desired reduction in pollution.

Notwithstanding the many important distinctions concerning regulations outlined above, the rhetoric of the Reagan Administration has been thoroughly opposed to the whole concept of Government regulation. But we have yet to see a definite implementation of the Administration's ideas. Price deregulation had already become a major activity under the Carter Administration for example in airlines and trucking.

The primary concern of the new Chairman of the Council of Economic Advisers Murray Weidenbaum, has been the costs of regulation to private industry, and one may expect further moves toward price deregulation. But there will also be powerful forces opposing further deregulation, both employers and unions, and trucking and, of course, the ever present agricultural lobby which has already shown its power.

More serious has been the attack on environmental protection from Secretary of Interior Watt. There appear to be definite pressures against steps for the preservation of land, both by relaxing controls over strip mining and by turning land management over to the states. It may be expected that air pollution controls will be weakened. The most definite step in quality deregulation so far has been the proposed abolition of the Consumer Product Safety Commission on the rather remarkable ground that it has been so successful as to become superfluous.

To sum up, quality regulation policy has not yet been articulated to any great extent by the Reagan Administration. Presumably budget policy has priority. But there is no reason to doubt that the Administration's announced beliefs will be translated into policy over the next few years, and that concern for safety and protection from environmental hazards will be subordinated. ☐

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