"REVOLUTION IN OUR ECONOMIC PHILOSOPHY"

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Meidinger Management Seminar
Louisville, Kentucky

August 31, 1981

Keynesian Approach is Wrong for the 1980's

A major revolution in economic thinking is underway - a retreat from the Lord Keynes' ideas that have dominated our economic policy for the past 35 years. In the decades ahead, this revolution is likely to have profound effects. It's called "supply side economics". The tax revolt is part of it. More on this in a moment.

Keynes' completed his major work in 1935. The British economy had been experiencing an unusually high rate of unemployment for 15 years. The traditional view that economic fluctuations are short-lived and self-correcting seemed to be faulty. Keynes developed a theory he believed more appropriate to the problems of his time. Whether or not his prescriptions were correct for the 30's, those ideas are not appropriate for the U.S. economy in the 1980's. Yet it was only ten years ago this month that Nixon declared: "We are Keynesian's now", at the moment when he abandoned the gold standard.

Keynes' view that unemployment reflected inadequate demand was simply a product of his depression experience. During the 30's unemployment in Britain rose to 30% and many of those unemployed were without work for a year or more. He advocated expansionary fiscal and monetary policy, including federal deficits, to stimulate consumer spending in hopes of reducing unemployment.

The Keynesian approach is not appropriate to our situation today. In 1979, when our unemployment rate was 6%, half of those who became unemployed were rehired within four weeks. Furthermore, half of the unemployed were less than 25 years old, and half of them were looking for their first job. The unemployed typically are young, have generally not lost their previous job, and have very short periods of unemployment. The problem is not that jobs are unavailable, but that those jobs are unattractive - at least relative to other alternatives.

Our unemployment is not due to inadequate demand but to adverse incentives. Generous benefits have intensified unemployment by encouraging the people to delay their return to work. Furthermore, the effect of the minimum wage has been to raise the level of unemployment among those with low skills.

Keynesian economists misinterpreted our 6% unemployment rate as an indication of inadequate demand for labor. They called for expansionary monetary and fiscal policy for the last 15 years. This misperception has been a significant reason for our high inflation during this period.

Fortunately there is the growing recognition that high unemployment cannot be lowered by expansionary demand policies, and that unemployment is made worse by labor disincentives.

We will see in the 1980's a more realistic appreciation of the nature of unemployment and efforts to reform labor market policies that currently raise the rate of unemployment.

Keynesian thinking also retarded our capital formation. He felt additions to capacity would not increase output unless demand was also stimulated. He ignored the role of capital accumulation in raising potential output. He feared increased savings would not lead to more investment - only depressed demand.

In Europe and Japan, Keynes' influence was much weaker than in the U.S. and Britain. They had an urgent need to rebuild capital stock depleted by World War II. As a result those countries developed policies designed to encourage saving while the U.S. and Britian developed policies to discourage saving and to encourage consumer spending instead.

Unfortunately our policies have been successful in depressing the rate of savings. The U.S. and Britain had among the lowest savings rates in the industrial world for the past two decades.

Our low savings rates caused low rates of investment and therefore low rates of productivity. Our 6% net new investment rate is less than half of the average of other industrial countries. Furthermore, half of our net investment rate has gone into housing and inventory, leaving only 3.8% of our GNP for increases in the net stock of plant and equipment. Since our labor force has been growing at a 2% rate for the last 20 years, the amount of capital per worker has only increased 1.8% a year. This is less than half the productivity rate for many industrial countries and one fourth the rate of Japan.

Any hope for raising our future standard of living hinges on improving this dismal statistic. If we save and invest more, this translates into increased productivity, a greater national income, and therefore a high standard of living.

We have a social security system that makes savings virtually unnecessary for many. We have credit market rules that encourage large mortgages and extensive consumer credit while limiting return available to the small saver. We have chronic government deficits that absorb private saving and shrink the resources available for investment. In addition, the high rate of inflation in the past decade, has interacted with the tax law, credit policies, and social security guarantees to discourage savings even more strongly.

"Supply Side Economics" to the Rescue

Fortunately, economic thinking about capital formation has now changed. There is now, at last, an understanding that a higher savings rate is necessary for increased investment which will stimulate productivity and our standard of living.

Although "supply side economics" has only begun to be reflected in legislative results, in this decade we are likely to see significant revisions of policies that currently depress private savings, including tax policies, social security benefits, and credit regulation.

In place of government intervention, there is a growing respect for the efficiencies of a free market. There is a new modesty about the government's ability to alleviate our economic and social ills. There is emerging a new view of unemployment, of saving, and of the role of government, which will bring better economic policies in the decades ahead.

What is "supply side economics"? It is part of a bigger revolution in the economics profession, one which recognizes that people respond to market incentives - that output is the direct result of the input, which in turn responds to incentives. Taxes on productive effort and on accumulation of capital impede output, employment, and living standards. Supply siders broadly define the tax burden not only as your personal and corporate taxes but also the inflation tax. For example, if you add the inflation taxes on securities to the standard measure of taxes you find that 2/3 of all taxes are not those shown in the budget but are the taxes eaten away by inflation. If you earn 15% on a savings account, and pay 1/3 of it in taxes, this leaves you with 10%, but if inflation is 10%, it leaves you with a real return of 0 after taxes and inflation. That is one reason why inflation control is a key priority in supply side economics.

People alter their behavior when incentives change. If you make an activity more attactive, people will engage in more of that activity. If you make it less attractive they will do less of it. Through changes in taxation, regulation, and government spending, you change the incentives. This changes people's behavior.

Why are there so many opposed to the supply side economics? Many economists used to feel that economic success could only be achieved if the government manipulates the economy. They feel threatened. Then too, Keynesianism was a convenient way for the government to acquire larger claims on the economy's resources without having to legislate higher tax rates. Your marginal tax rate goes up as your salary increases. Secretary of Treasury Don Regan estimates that half of the taxpayers would have been in the 50% tax bracket before the end of this decade, but for the recent tax cut.

The supply side approach is also politically threatening to vested interests which have benefited from large federal spending programs.

Keynes said that the purpose of a tax cut was to produce a budget deficit in order to stimulate aggregate demand. The Reagan Administration's thinking is totally different. The purpose of the recent tax cut is to reduce the marginal rate of taxation in an effort to change behavior rather than raise total demand. In the past high marginal tax rates made it cheaper for a person to spend rather than to save.

Here is an example of the problem. An Englishman with $50,000 must decide whether to buy a Rolls Royce or invest money at 17% interest. His marginal tax bracket is 98%. Therefore, after taxes the $8,500 interest income off the $50,000 is only $170.00 a year. Therefore, after taxes the price of owning a Rolls Royce is merely to forego $170.00 a year interest income. Consumption is more alluring than savings.

We do not expect massive effects on individual behavior from the recently passed tax act of 1981. Dr. John Rutledge, president of Claremont Economic Institute, estimates that three years from now, after all this massive tax cutting, taxes will be about 20% of GNP versus 21% now. However, the cumulative effect could be substantial. For example, if the savings rate goes up two percentage points you are talking about an additional $42 billion a year available to the capital markets.

Since 1965, a family with twice the median income has experienced a 100% increase in marginal tax rate. Every year leisure and current consumption become cheaper in terms of sacrificed income either from work or saving. This affects things like work attitudes, absenteeism, willingness to accept overtime, savings rates, or willingness to assume risks.

As for the supply side effects on work attitudes, if the willingness to assume overtime rises enough that the work week is lengthened by only 1/2 an hour, you add $25 billion to output. Small changes by individuals can have large aggregate results.

The tax act does lower top brackets significantly (from 70% to 50%). The capital gains tax is significntly reduced (from 28% to 20%), and there are some additional incentives for savers, including a $2,000 deductible contribution to an IRA, even though the taxpayer already participates in a retirement plan.

There is ample evidence that cuts in marginal tax rates provide stimulus. Marginal tax rates have been consistently cut in Japan and their economic performance has been superior to our own. Art Laffer, professor of economics at the University of Southern California, says that there is a huge body of evidence generated which shows incentives do play a major role in economic growth. Tax cuts have recently provided significant economic stimulus in California, New York and Massachusetts. Delaware has attracted significant banking industry employment by offering favored tax treatment to large New York banks. President Kennedy's tax cut in 1963 slowed growth in consumer spending, stimulated savings, and enabled capital spending to jump sharply. The economy subsequently prospered and unemployment and inflation stayed at low levels.

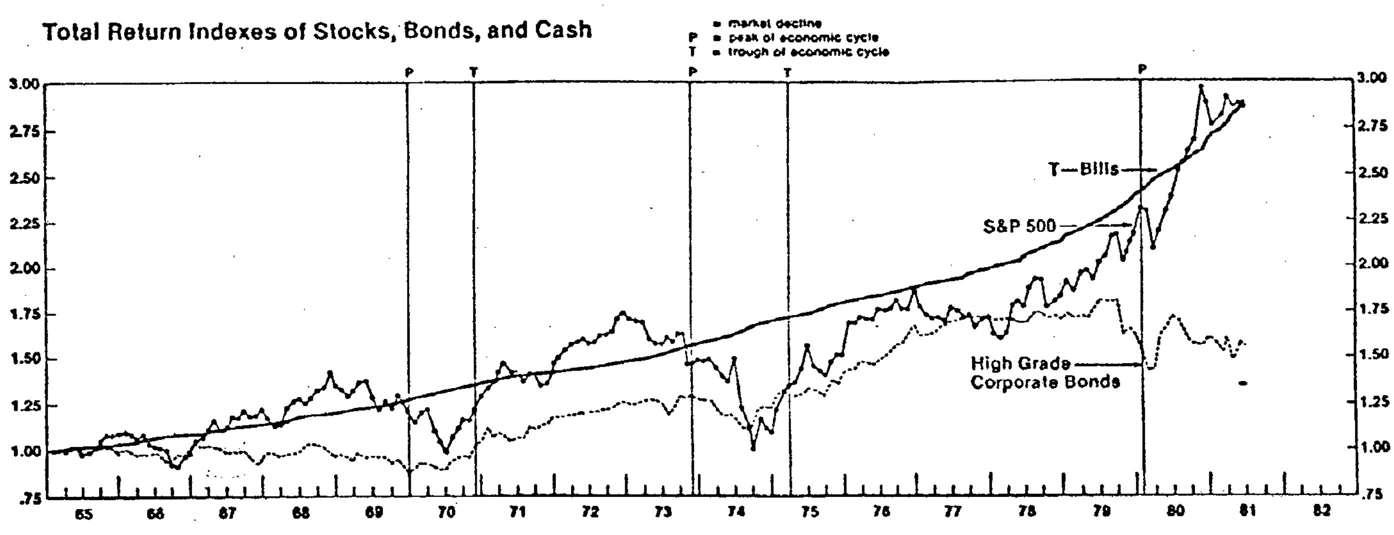
Cuts in marginal tax notes play a critical role in generating President Reagan's optimistic 5 year economic forecast. Their forecasts of a real GNP growth of 4 1/4% over the next 5 years is considerably faster than the 3 1/4% rate of the past five. They expect inflation to be below 5% by 1985 and short term interest rates below 6%. Unemployment is projected below 6% and the budget is projected to be in balance by 1984.

But Something has Gone Wrong

Something is wrong. On the one hand, inflation has been dropping for over a year. This is supposed to be good news for the bond market.

However, bond prices have continued to collapse. They are an astounding 30% below mid 1980 levels.

Bond returns have badly lagged either stocks or Treasury Bills since the mid 60's. As an investment advisor I must tell you it's humbling to note that Treasury Bills have done as well as the stock market (the S&P 500) for the last 17 years.



Before you let your pension clients give up on the bond market, remind them that today's 17% yield on bonds exceeds the total return on balanced pension funds in all but three of the last 18 years (1971, 1975, and 1980). In only 8 out of 51 five-year periods since 1926, have common stocks averaged any better than 17%, and none of those have occurred since 1958.

With budget and tax victories under its belt, the White House now finds high interest rates a huge impediment to its economic objectives. Considerable progress has been made in inflation this year, as noted earlier. Based on experience, interest rates should have been tumbling this summer, but instead they have been hovering at record levels. The current high rates were predicted only by those who focus on supply and demand in the credit markets and give no weight to the record level of real rates (the nominal interest rate adjusted for inflation). As the Wall Street Journal recently said; "If you look at the borrowing demands imposed by a relatively strong economy and a huge government deficit, the supply of credit created by an anemic savings rate and a slow pace of money creation by the Federal Reserve, you, of course, see enormous interest rates".

These unexpectedly high interest rates are adding $10 billion to this year's federal deficit. They contributed to last month's reversal of the slower inflation trend. Reagan's patience with high interest rates will not last long. It is only four months until the 1982 election year. The White House has no choice but to turn its attention to the abysmal state of the bond market. Hopes that the legislative victory on the budget would help the bond market have been dashed. There is growing apprehension in the administration, according to political economist Jude Wanniski, that monetarists who control Fed policy will not be able to brake inflationary expectations with high interest rates.

Will the Dollar be as Good as Gold?

Wanniski says supply side economists in the Administration are ready to do battle on monetary policy. Their aim is dollar convertibility - the restoration of the gold standard. Their objective is to win a commitment by the Fed by the end of this year, recognizing that the process of a modern international gold standard would take a year or two. As unlikely as it may seem that such an objective can be met, chances will improve this fall as Reagan and Republican leaders observe continued failure of monetarists in controlling money supply and interest rates.

This month marks the 10th aniversary of President Nixon's closing of the gold window, thus opening the door for this experiment with monetarism, a "paper standard". Lewis Lehrman, a member of the Gold Commission, said at the initial meeting last month: "Since 1971 there has been a decade of dramatic price instability - unique in our history. The interest rates paid by the Federal government for its money today are more than twice the 7% rates paid during the Civil War when the existence of the nation was threatened." He raised the question: "Are the problems of gold really that serious? Are not the problems of the present system more profound than those of the gold standard?"

To supply side economists the attempts by monetarists to manage the currency through academic formulae are doomed to failure - bureaucrats are no match for the market place in determining the correct amount of money to be supplied by the central bank at any given time.

Wanniski recently told Treasury Secretary Regan he was pursuing a contradictory policy by saying: "Your tax reforms are encouraging people to increase production because you let them keep more of their output after taxes. But your monetarists in the Treasury and at the Fed see this as an inflationary impulse and are trying to choke off economic activity with high interest rates".

Monetarism does not work. Israel's central bank, a monetarist outpost, has produced triple-digit inflation. Thatcher accepted Friedman's philosophy and after two years of experiments the British unemployment rate is 11 1/2%, inspiring urban riots, and inflation is running over 20%.

In due course we will discover that we should stop trying to control the quantity of money and start worrying about the quality of money, or the value of the dollar in the future. At that point inflation and interest rates will drop fast and the economy will prosper. Long term capital markets, the S&L's would become viable again. As Art Laffer recently said: "Restoration of confidence in the dollar by way of a gold standard would have enormously positive economic benefits with very few negative side effects". I believe President Reagan is for it. It may happen sooner than you think.