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TAX CUTS: A REMEDY FOR INFLATION

BACKGROUND

President Reagan's proposal to reduce federal income tax rates 30 percent over three years has sparked a sharp controversy. Proponents of the tax proposal assert that a reduction of marginal tax rates would revitalize the economy by producing non-inflationary economic growth. Critics of the plan, on the other hand, contend that such a policy would serve only to exacerbate inflationary pressures within the economy.

KEYNESIAN ASSUMPTIONS

Opposition charges that the Reagan income tax cut would be inflationary are based on the Keynesian assumption that consumption is a constant proportion of additional disposable income, and that a reduction in taxes would inevitably lead to demand-pull inflation by setting off a multiplied spending process. These critics, however, have been unable to explain why it would be inflationary when people spend their own money, but not when the government spends for them. If the tax cut is accompanied by a spending reduction, then any increase in disposable income from the tax would be offset by a corresponding reduction in income for recipients of federal payments. In the event of a deficit, bonds are sold to the private sector, thereby taking money from the purchasers of bonds and transferring it to the Treasury. There is no added demand on the economy because purchasing power has simply been shifted from one group to another.

Moreover, the primary objective of supply-side economics is not to stimulate aggregate demand, but to increase incentives to earn more taxable income. Lower marginal tax rates are designed to encourage work and increase savings as well as investment by making leisure, consumption, and tax shelters relatively more expensive. The reduction in tax rates is actually expected to raise total tax revenues through expanding production and, consequently, an enlarged tax base. Inflationary pressures would decrease because there would be a greater supply of goods and services relative to the supply of money. High taxes have actually contributed to inflation by discouraging production without limiting the growth of the money supply.

A tax cut would only be inflationary when the Federal Reserve finances any resulting deficit by creating new money. Opponents of the proposed tax cuts claim that the projected deficits of the program in the early years would be pernicious to the economy. These deficits, they argue, would increase government borrowing. The increased demand for funds would raise interest rates, and thereby inhibit economic activity in the private sector because private borrowers would be displaced. This, in turn, would fuel inflation by compelling the Fed to monetize the debt. Conventional Keynesian analysis, however, again ignores the effects of incentives altered by the tax proposal. By increasing after-tax income, the reduction in tax rates would have an immediate positive impact on savings. This growth in savings could be used to cover these deficits without putting pressure on interest rates or on the Fed to print money. Then, as revenue reflows begin reducing the deficit, the additional private savings would add further stimulus to the economy.

KENNEDY TAX CUT

The current Reagan tax proposal is often compared to the Kennedy tax cut of 1964, which was similar in intent. In the 1963 Economic Report of the President, President Kennedy pointed out that reducing taxes is a key to reviving the economy, even if it results in a deficit:

> Tax reduction...sets off a process that can bring gains to everyone, gains won by marshalling resources that would otherwise stand idle -- workers without jobs and farm and factory capacity without markets. Yet many taxpayers seem prepared to deny the nation the fruits of tax reduction because they question the financial soundness of reducing taxes when the Federal budget is already in deficit. Let me make clear why... reducing taxes is the best way open to us to increase revenues... [U]ntil we restore full prosperity and the budget-balancing revenues it generates, our practical choice is not between deficit and surplus but between deficits born of waste and weakness and deficits incurred as we build our future strength.

By reducing individual and corporate tax rates, the Kennedy program produced substantial improvements in employment, output, wages, savings, and investment. As a result, the tax cut was self-financing. Because the average taxpayer is in a much higher tax bracket today, reducing tax rates should have an even greater influence on savings. This growth in savings, together with budget cuts and revenue reflows, should insure the success of the Reagan economic program in restoring real economic growth.

CONCLUSION

Finally, rising rates of inflation and unemployment, together with declining productivity, have created a climate ill-suited to economic growth. Because expectations play such an essential role in the long-term decision-making process of both businesses and individuals, it is important that the Reagan proposal is not viewed as just a one-year tax cut, but rather a multi-year plan. If enacted, a multi-year reduction in tax rates would produce greater benefits more rapidly by improving the prospects for real rewards from productive activities. Such a cut would restore confidence and encourage economic activity by breaking the "cycle of negative expectations." President Kennedy once said: "An economy hampered by restrictive tax rates will never produce enough revenue to balance the budget -- just as it will never produce enough jobs or enough profits."

Peter G. Germanis
Policy Analyst