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WE STILL NEED A GOOD TAX CUT

The Federal Reserve has lowered short term interest rates three times since late September. On December 3, central banks of the 11 European Union nations moving to adopt the Euro as their common currency coordinated an interest rate cut. Japan is assisting its struggling banks with a major capital infusion.

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The U.S. and European interest rate reductions were fully justified by declining inflation fears and by the associated fall in long term market interest rates on government bonds and other low risk securities. The central bankers were as much following market trends as leading them. The monetary authorities were also seeking to reassure credit markets that the Asian turmoil would not be allowed to cause worldwide credit market problems, and to boost liquidity in the face of increased nervousness about holding riskier securities.

> ***If the United States, Europe, and Japan are to have strong economies in 1999, their tax and spending authorities must not rest on the laurels of the monetary authorities.***

Unfortunately, there is danger that Congress, the President, and the governments of the European Union and Japan may view the easing of monetary policy by the central banks, and the Japanese bank bailout, as substitutes for needed changes in their respective fiscal and regulatory policies. The governments may think, wrongly, that there is no longer any need to adopt pro-growth tax and regulatory relief to boost real output and create jobs. If the United States, Europe, and Japan are to have strong economies in 1999, their tax and spending authorities must not rest on the laurels of their monetary authorities and bank regulators.

The idea that monetary policy and fiscal policy can substitute for one another in boosting the economy is a relic of the Keynesian era. The old Keynesian view was that all the supposedly "stimulative" economic policy tools available to government -- faster money creation, higher government spending, and tax cuts -- boost real output in the same way, by pumping up spending in the economy. In that view, if one policy tool is being used to do the job, the others can be left idle, or even moved in the opposite direction. For example, it is assumed to be O.K. to raise taxes so long as the resulting economic "drag" is offset by easier money or higher government spending. The policies can supposedly be mixed and matched to fine-tune total spending to raise output just to capacity, achieving full employment without inflation.

We now know that Keynesian "demand only" economics is not valid. Monetary and fiscal policies work on different aspects of the economy, and work in different ways. The policies affect capacity by affecting the supply of labor and capital and by altering perceptions of risk. Fine tuning is impossible in a

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large, complex economy, particularly when economic policy tools act in a manner quite different from that assumed by the policy community.

Monetary policy chiefly controls the price level, and only contributes to real output by not rocking the boat. Faster money growth results in higher inflation, not higher real GDP. In fact, inflation raises taxes on capital investment by understating the cost of replacing plant and equipment, and thereby discourages investment and output.

> ***Fiscal authorities in the United States, Europe, and Japan have often relied on their central banks to save them from the consequences of bad budget and regulatory policies. It has never worked before, and it won't work now.***

Furthermore, if monetary policy is erratic, it increases risk and uncertainty, which are obstacles to production. Working for stable prices is the best thing monetary policy can do for real output.

A tax cut boosts real output only if it involves lower taxes, at the margin, on labor and capital income, encouraging people to supply additional labor, capital, and output. Lower taxes at the margin can be accomplished by lowering statutory marginal tax rates on labor and capital income, by extending IRA or pension-type treatment to all saving and ending double taxation of corporate income, and by allowing fuller, faster expensing of the cost of investment. When tax rate cuts make production more rewarding and less costly, they shift supply conditions first, which boosts output and payments to workers and savers, which boosts demand as well. A tax cut does not act initially by boosting "disposable income" and demand, because the government must either borrow the money back to maintain spending (if it is running a deficit), reduce its repayment of debt (if it is running a surplus), or cut government spending, all of which negate the initial demand effect.

> ***All three regions need less government intrusion into the economy and the right kind of pro-growth tax relief.***

Government spending does not add to total output. It crowds out private sector activity by hiring away labor and capital directly for its own use, or by purchasing goods and services that would otherwise be available to individuals and businesses. Borrowing to pay for the government spending would reduce private spending. Taxes levied to pay for the spending would cut private spending and, furthermore, would create disincentives to work, save, and invest, shrinking the available resource pool.

Where does all this leave us? The U.S. expansion continues, at a slowly diminishing rate; it could be stronger. Europe clings to swollen government budgets and excessive regulation, and stays mired in high unemployment. Printing money won't help. Japan's government overspends and overregulates. It is cutting taxes, but much of the tax relief is of a type that will not increase incentives for private sector growth. Furthermore, the government is borrowing the tax cut back to fund more government spending, roiling credit markets.

Fiscal authorities in the United States, Europe, and Japan have often relied on their central banks to save them from the consequences of bad budget and regulatory policy. It has never worked before, and it won't work now. All three regions need less government intrusion into the economy and the right kind of pro-growth tax relief.

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