Phillips Curve, R.I.P.

A top Reagan economist paints a damaging picture of an economic tradeoff that continues to confound.

By Paul Craig Roberts

The Phillips Curve is the modern-day version of the unicorn. People believe in it, but no one can find it. The Fed has been searching for it for a decade and the Bank of Japan for two decades. So has Wall Street.

Central banks' excuse for their massive injections of liquidity in the twenty-first century is that they are striving to stimulate the 2 percent rate of inflation that they think is the requirement for sustained rises in wages and GDP. In a total contradiction of the Phillips Curve, in Japan massive doses of central bank liquidity have resulted in the collapse of both consumer and financial asset prices. In the United States, the result has been a large increase in stock averages propelled by unrealistic price-to-earning ratios and financial speculation resulting in Tesla's capitalization at times exceeding that of General Motors.

In effect, pursuit of the Phillips Curve has become a policy of ensuring the financial stability of banks by continually injecting massive amounts of liquidity. The result is greater financial instability. The Fed is now confronted with a stock market disconnected from corporate profits and consumer disposable income, and with insurance companies and pension funds that have been unable for a decade to balance equity portfolios with interest-bearing debt instruments. Crisis is everywhere in the air. What to do?

The Phillips Curve has been working its mischief for a long time. During the Reagan Administration, the Phillips Curve was responsible for an erroneous budget forecast. In the twenty-first century, the Phillips Curve

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is responsible for an enormous increase in the money supply. The Reagan Administration paid a political price for placing faith in the Phillips Curve. The price for the unwarranted creation of money by central banks in the twenty-first century is yet to be paid.

The Phillips Curve once existed as a product of Keynesian demand management and high tax rates on personal and investment income. Policymakers pumped up consumer demand with easy money, but high marginal tax rates impaired the responsiveness of supply. The consequence was that prices rose relative to real output and employment. Supply-side economists said the solution was to reverse the policy mix: a tighter monetary policy and a "looser" fiscal policy in terms of lower marginal tax rates that would increase the responsiveness of supply.

During the 1980s, the economics establishment was too busy ridiculing supply-side economics as "voodoo economics," "trickle-down economics," "tax cuts for the rich," and for allegedly claiming that tax cuts pay for themselves, to notice what I pointed out at the time: the dreaded Phillips Curve with its worsening trade-offs had disappeared. The high GDP growth rates of the economic expansion beginning in 1983 were accompanied by inflation that collapsed from near double-digit levels to 3.8 percent in 1983 and 1.1 percent in 1986. Of course, the economics establishment wasn't interested in such embarrassing results, and so the story became the "Reagan deficits." The establishment reduced supply-side economics to the claim that tax cuts paid for themselves, and the deficits proved supply-side economics to be wrong. Case closed. This remains the story today as told by Wikipedia and in economic classrooms.

The implementation of the Reagan Administration's policy was disjointed, because then-Fed Chairman Paul Volcker saw the supply-side policy as a massive fiscal stimulation that would send already high inflation rates soaring. Concerned that monetarists would blame him for what he thought would be the inflationary consequences of irresponsible fiscal stimulus, Volcker slammed on the monetary brakes two years before the tax rate reductions were fully implemented. This was the main reason for the budget deficits, not a "Laffer Curve" forecast that was not made. The Treasury's forecast was the traditional static revenue estimate that every dollar of tax cut would cost a dollar of revenue.

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In effect, the Phillips Curve became an ideology, and economists couldn't get free of it. Consequently, they have misunderstood "Reaganomics" and its results and subsequently policymakers have inflicted decades of erroneous policies on the world economy.

As so many have observed, if we don't understand the past, we cannot understand the present. To understand the past, let's begin with Reaganomics.

So what was Reaganomics?

"Reaganomics" was the media's name for supply-side economics, which was a correction to Keynesian demand management. Worsening "Phillips Curve" trade-offs between employment and inflation became a policy issue during the Carter Administration. The Keynesians had no solution except an incomes policy that had no appeal to Congress. This opened the door to a supply-side solution.

Demand management treats the aggregate supply schedule as fixed. Fiscal and monetary policies were assumed to have no impact on aggregate supply, a function

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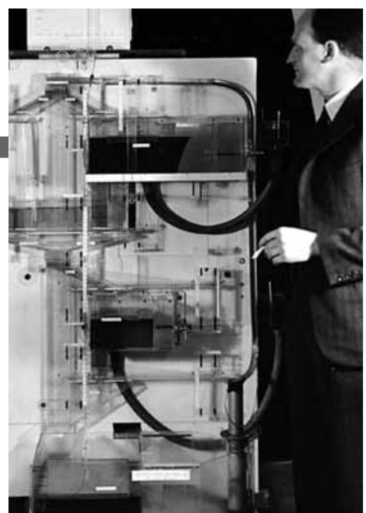
Bill Phillips

Alban William Housego Phillips (1914–1975) was an influential New Zealand economist who spent most of his academic career as a professor of economics at the London School of Economics. His best-known contribution to economics is the Phillips Curve, describing an inverse relationship between unemployment and inflation. He also designed and built the MONIAC hydraulic economics computer in 1949.



Bill Phillips with his MONIAC hydraulic economics computer.

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of technology and resources. Changes in marginal tax rates, for example, would, if expansionary (lower rates), move aggregate demand along the aggregate supply schedule to higher employment; if contractionary (higher rates), the policy would reduce inflation by reducing aggregate demand and employment.

Supply-side economists said that some fiscal policies directly shift the aggregate supply schedule and that neglect of this by Keynesians was the explanation for the worsening Phillips Curve trade-offs. The Keynesian policy stimulated demand but high tax rates held back the responsiveness of supply, so prices rose relative to output and employment. This was the explanation of the worsening Phillips Curve trade-offs.

Supply-side economists pointed out that marginal tax rates affect two important relative prices. One is the price of leisure in terms of forgone current income. The other is the price of current consumption in terms of forgone future income. Thus, marginal tax rates affect both the supply of labor and the supply of savings. The higher the tax rate on labor income, the cheaper is leisure. The higher the tax rate on investment income, the cheaper is current consumption or what is the same thing, the higher is the opportunity cost of saving and investing.

Supply-side economists said that the solution to the worsening Phillips Curve trade-offs was to change the policy mix: tighten monetary policy and "loosen" fiscal policy by lowering marginal tax rates.

Despite the clarity of my explanations in *The Supply-Side Revolution* (Harvard University Press, 1984), *The New Palgrave Dictionary of Money and Finance* (1992), *The McGraw-Hill Encyclopedia of Economics* (1994), *Zeitschrift für Wirtschaftspolitik* (38 Jahrgang 1989), *Rivista di Politica Economica* (Maggio 1989), *The Public Interest* (Fall 1988) and http://www.paulcraigroberts.org/2017/07/17/supply-side-economics-theory-results/, the myth has been established that supply-side economics is about tax cuts paying for themselves. As the Wikipedia entry, for example, puts it, "The Laffer curve is one of the main theoretical constructs of supply-side economics." This is nonsense. The issue that the policy addressed was the worsening Phillips Curve trade-offs, not raising revenues for the government. As all official documents show,

The Phillips Curve disappeared long before globalization took off.

the Treasury's revenue forecast of the Reagan tax rate reduction is the Treasury's static revenue forecast that every dollar of tax reduction will lose a dollar of revenue.

Where then did the "Reagan deficits" come from? The answer is that they came from the Phillips Curve. The

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Council of Economic Advisers took the position that a forecast that departed significantly from the Phillips Curve belief that the economy could not grow while inflation declined would lack credibility. A forecast of rapidly falling inflation would especially discredit a budget that encompassed a tax rate reduction that would be, despite our explanation, interpreted as a demand stimulus policy. The budget director, David Stockman, and the White House chief of staff took the position that the Republican Senate would not vote for a tax rate reduction that enlarged the budget deficit. Therefore, against my advice (I was Assistant Secretary of the Treasury for Economic Policy), the inflation numbers in the six-year (1981–1986) budget forecast were raised to accommodate the Phillips Curve and the Republican fear of budget deficits.

Having been present at Fed Chairman Paul Volcker's meetings with the Fed's outside consultants, I heard them tell Volcker that the administration's policy was a massive fiscal stimulus and that, in Alan Greenspan's words, "monetary policy is a weak sister; at best it can conduct a weak rear-guard action." I saw that Volcker was not going to follow the Treasury's request to gradually reduce the growth rate of money, but in order to protect himself would throw on the brakes before any part of the phased-in tax rate reduction had gone into effect.

And that is what Volcker did. Inflation collapsed relative to forecast. The collapse in inflation collapsed GDP and the tax base and is the origin of the budget deficits. The Reagan inflation forecast was below the Carter Administration and CBO forecasts, but high relative to actual inflation. For example, Reagan's budget forecast inflation rates (1981–1986) of 11.1 percent, 8.3 percent, 6.2 percent, 5.5 percent, 4.7 percent, and 4.2 percent. Actual inflation was 8.9 percent, 3.8 percent, 3.8 percent, 3.9 percent, 3.8 percent, and 1.1 percent.

The budget deficits, which had been hidden by a curtsy to the Phillips Curve and Republican deficit phobia, became a weapon in the Democrats' hands. As a member of the Senate staff during 1977–1978, I succeeded in securing the support of leading Democrats, such as Russell Long, chairman of the Senate Finance Committee, Lloyd Bentsen, chairman of the Joint Economic Committee, and Sam Nunn on the Armed Services Committee, for a supply-side policy. Indeed, the first Senate reports endorsing a supply-side policy were issued by the Joint Economic Committee under Bentsen's chairmanship in 1979 and 1980. Support for a supply-side policy had also spread into the House Democrats. House Speaker Tip O'Neill introduced a Democratic supply-side alternative to Reagan's. The only way Reagan could differentiate his tax cut from the Democratic alternative was by indexing the tax rates for inflation (beginning in the mid-1980s).

Despite the willingness of Democrats to support a supply-side policy, the White House staff wanted to give Reagan a "political victory" by picking a fight and cutting the Democrats out of the tax bill. This "victory" turned to ashes when the Phillips Curve proved to be bogus. Democrats, media, and academics turned on the administration, accusing it of a Laffer Curve forecast, and Wall Street economists kept interest rates high with their absurd prediction that budget deficits resulting from the collapse of inflation would cause inflation to explode.

In the United States, the Phillips Curve has disappeared. Not even a decade of quantitative easing and an enormous expansion in the Fed's balance sheet has been able to bring it back. The Fed is still trying and remains unsure whether it can raise the short-term interest rate by 25 basis points. And this despite enormous budget deficits. The miniscule rate increases about which the Fed worries are not even real increases as they do not offset the low reported inflation.

Those who recognize the Phillips Curve's demise attribute it to globalization; that is, to the offshoring of high-productivity, high-value-added manufacturing jobs that have destroyed manufacturing unions. However, the Phillips Curve disappeared long before globalization took off. The U.S. 70 percent tax rate on investment income and the 50 percent tax rate on personal income from the Phillips Curve era have been absent for thirty-five years. To resurrect the Phillips Curve, the responsiveness of output to demand would have to again be impaired. ◆